Supreme Court, U.S.
FILED

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No.

In the Supreme Court of the United States

WINN-DIXIE STORES, INC. AND SUBSIDIARIES,

PETITIONERS,

v.

COMMISSIONER OF INTERNAL REVENUE,

RESPONDENT.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE ELEVENTH CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

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158 pp

QUESTIONS PRESENTED

1. Whether the Eleventh Circuit erred by disallowing the tax deductions at issue on the basis of a judicially-created "sham transaction" doctrine where specific and comprehensive provisions of the Internal Revenue Code establish that the deductions were authorized by Congress.

2. Whether the Eleventh Circuit erred by characterizing Petitioners' program to purchase genuine life insurance policies from an unrelated insurance company through cash payments and legally enforceable policy loans as a "sham" on the basis of erroneous legal standards for identifying "sham transactions."

PARTIES TO THE PROCEEDING

The parties include the following:

Winn-Dixie Stores, Inc. and Subsidiaries, Petitioners
Astor Products, Inc., Petitioner
Deep South Distributors, Inc., Petitioner
Deep South Products, Inc., Petitioner
Dixie Darling Bakers, Inc., Petitioner
Dixie-Home Stores, Inc., Petitioner
Dixie Packers, Inc., Petitioner
Economy Wholesale Distributors, Inc., Petitioner
Fairway Food Stores, Inc., Petitioner
Foodway Stores, Inc., Petitioner
Kwik Check Supermarkets, Inc., Petitioner
Monterey Canning Co., Petitioner
Save-Rite Foods, Inc., Petitioner
Sunbelt Products, Inc., Petitioner
Superior Food Company, Petitioner
Table Supply Food Stores Co., Inc., Petitioner
W-D Transfer, Inc., Petitioner
Winn-Dixie Atlanta, Inc., Petitioner
Winn-Dixie Charlotte, Inc., Petitioner
Winn-Dixie Greenville, Inc., Petitioner
Winn-Dixie Handyman, Inc., Petitioner
Winn-Dixie Louisiana, Inc., Petitioner
Winn-Dixie Louisville, Inc., Petitioner
Winn-Dixie Montgomery, Inc., Petitioner
Winn-Dixie Raleigh, Inc., Petitioner
Winn-Dixie Supermarkets, Inc., Petitioner
Winn-Dixie Supermarkets of Illinois, Inc., Petitioner

Winn-Dixie Supermarkets of West Virginia, Inc., Petitioner
Winn-Dixie Texas, Inc., Petitioner
Commissioner of Internal Revenue, Respondent

RULE 29.6 STATEMENT

Petitioner Winn-Dixie Stores, Inc. is the parent corporation of the subsidiaries listed above. No publicly held company owns 10% or more of Winn-Dixie Stores, Inc.'s stock.

TABLE OF CONTENTS

Page

QUESTIONS PRESENTED i

PARTIES TO THE PROCEEDING ii

RULE 29.6 STATEMENT iv

TABLE OF CONTENTS v

TABLE OF AUTHORITIES vii

OPINIONS BELOW 1

STATUTORY PROVISIONS INVOLVED 1

JURISDICTION 1

STATEMENT OF THE CASE 1

REASONS FOR GRANTING THE WRIT 8

I. THE ELEVENTH CIRCUIT'S DETERMINATION THAT THE SHAM TRANSACTION DOCTRINE TRUMPS THE TERMS OF I.R.C. § 264 CONFLICTS WITH THE DECISIONS OF THIS COURT AND THE D.C. CIRCUIT 10

A. The Plain Language Of The Code Leaves No Doubt That Congress Authorized The Deductions Taken By Winn-Dixie 10

B. The Eleventh Circuit's Reasoning Establishes The Need For This Court's Intervention 14

C. The Holding Of The Eleventh Circuit Squarely Conflicts With The Settled Law Of The D.C. Circuit 18

II. THE ELEVENTH CIRCUIT'S PRE-TAX PROFIT TEST FOR ECONOMIC SUBSTANCE CONFLICTS WITH PRECEDENTS OF THIS COURT AND OTHER CIRCUITS 21

III. THE ELEVENTH CIRCUIT'S REQUIREMENT THAT A TRANSACTION MUST ALWAYS BE MOTIVATED BY A NON-TAX "BUSINESS NEED" CONFLICTS WITH THE DECISIONS OF THIS COURT AND OTHER COURTS OF APPEALS 28

CONCLUSION 29

TABLE OF AUTHORITIES

CASES

ACM Partnership v. Commissioner,
157 F.3d 231 (3d Cir. 1998), *cert. denied*,
526 U.S. 1017 (1999) 29

Brown v. Gardner,
513 U.S. 115 (1994) 11

Campbell v. Cen-Tex, Inc.,
377 F.2d 688 (5th Cir. 1967) 6

Compaq v. Commissioner,
No. 00-60648, 2001 WL 1662035
(5th Cir. Dec. 28, 2001) 25, 29

Cook v. Commissioner,
941 F.2d 734 (9th Cir.),
cert. denied, 502 U.S. 857 (1991) 19

DeMartino v. Commissioner,
862 F.2d 400 (2d Cir. 1988) 28

Fabreeka Products Co. v. Commissioner,
294 F.2d 876 (1st Cir. 1961) 23-24, 27

Ferguson v. Commissioner,
29 F.3d 98 (2d Cir. 1994) 29

Fox v. Commissioner,
56 T.C.M. (CCH) 863 (1988) 19

Frank Lyon Co. v. United States,
435 U.S. 561 (1978) 21-23, 25, 27, 28

Gardner v. Commissioner,
954 F.2d 836 (2d Cir.), *cert. denied sub nom.*
Falk v. Commissioner, 504 U.S. 910 (1992) 19

Gregory v. Helvering,
293 U.S. 465 (1935) 8, 15, 28

Hilton v. Commissioner,
671 F.2d 316 (9th Cir.),
cert. denied, 459 U.S. 907 (1982) 29

Horn v. Commissioner,
968 F.2d 1229 (D.C. Cir. 1992) 12, 18-21, 28

Hunt v. Commissioner,
938 F.2d 466 (4th Cir. 1991) 29

James v. Commissioner,
899 F.2d 905 (10th Cir. 1990) 29

Kirchman v. Commissioner,
862 F.2d 1486 (11th Cir. 1989) 15

Knetsch v. United States,
364 U.S. 361 (1960) 7, 16, 22-23, 26, 28

Lerman v. Commissioner,
939 F.2d 44 (3d Cir.),
cert. denied, 502 U.S. 984 (1991) 19

Lukens v. Commissioner,
945 F.2d 92 (5th Cir. 1991) 30

Maysteel Products, Inc. v. Commissioner,
287 F.2d 429 (7th Cir. 1961) 23-24, 27

Northern Indiana Public Service Co. v. Commissioner,
115 F.3d 506 (7th Cir. 1997) 24, 30

Rice's Toyota World, Inc. v. Commissioner,
81 T.C. 184 (1983) 29

Rice's Toyota World, Inc. v. Commissioner,
752 F.2d 89 (4th Cir. 1985) 21-22, 23, 28

Rose v. Commissioner,
868 F.2d 851 (6th Cir. 1989) 29

Russello v. United States,
464 U.S. 16 (1983) 12

Sacks v. Commissioner,
69 F.3d 982 (9th Cir. 1995) 24-26, 27, 29

Shriver v. Commissioner,
899 F.2d 724 (8th Cir. 1990) 23

Sochin v. Commissioner,
843 F.2d 351 (9th Cir.),
cert. denied, 488 U.S. 824 (1988) 29

UPS v. Commissioner,
254 F.3d 1014 (11 Cir. 2001) 29

Yosha v. Commissioner,
861 F.2d 494 (7th Cir. 1988) 24

STATUTES

28 U.S.C. § 1254(1) 1

Life Insurance Tax Act of 1993
S. 1992 98th Cong. (1983) 12

Deficit Reduction Act of 1984, Pub. L. No. 98-369,
98 Stat. 494 (1984) 12

Fla. Stat. Ann. § 627.4585(3)(b) 4

Health Insurance Portability & Accountability Act
of 1996, Pub. L. No. 104-191, 110 Stat. 1936 (1996) 13

I.R.C. § 72(e) (West 1993) 2

I.R.C. § 101(a)(1) (West 1993) 2

I.R.C. § 163 (West 1993) 2, 11

I.R.C. § 165(c) (West 1993) 12

I.R.C § 264 (West 1993) 2, 3, 11, 12, 20-21

I.R.C. § 7702 (West 1993) 3

Tax Reform Act of 1986, Pub. L. No. 99-514,
100 Stat. 2085 (1986) 12, 19

LEGISLATIVE MATERIALS

H.R. Rep. No. 98-432, pt. 2, (1984), *reprinted in* 1984 U.S.C.C.A.N. 697 12

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David P. Hariton, *Sorting Out the Tangle of Economic Substance*, 52 Tax Lawyer 235 (Winter 1999) 26

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The Tax Court's opinion (App. 7a-63a) is available at 113 T.C. 254. The Eleventh Circuit's opinion (App. 1a-6a) is published at 254 F.3d 1313.

STATUTORY PROVISIONS INVOLVED

The Appendix (App. 66a-108a) reproduces the provisions of I.R.C. sections 163, 264, and 7702 involved in this case.[1]

JURISDICTION

The Eleventh Circuit entered judgment on June 28, 2001 and denied the petition for rehearing *en banc* on September 28, 2001. Justice Kennedy extended the time to file this Petition to and including January 10, 2002. Applic. No. 01300444. This Court has jurisdiction pursuant to 28 U.S.C. § 1254(1).

STATEMENT OF THE CASE

1. Although the "sham transaction" analysis used by the Eleventh Circuit has sweeping implications for tax planning and litigation generally, the particular transaction disregarded as a "sham" in this case was a leveraged life insurance program. A brief background of the Internal Revenue Code provisions governing life insurance policies is therefore essential to understanding the decision below and its implications.

For decades, Congress has encouraged and subsidized the purchase of life insurance by bestowing substantial tax advantages. First, death benefits are generally excluded

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[1] Unless otherwise indicated, this Petition and the Eleventh Circuit's and the Tax Court's opinions refer to statutory provisions in the Internal Revenue Code of 1993. App. 3a n.1, 7a. References to documents in the record are referred to by the document numbers assigned in the "United States Tax Court Docket Entries," dated April 12, 2000, and by page or paragraph number, as appropriate. Exhibits separately certified by the Tax Court are referenced by exhibit number and page number.

from gross income, I.R.C. § 101(a)(1), even though they may represent a substantial net increase in wealth and would otherwise constitute income under general tax principles. Second, investment returns credited to the account values of life insurance contracts (often called "inside build-up") are not taxed, so long as those returns are maintained in the policies. I.R.C. § 72(e). Inside build-up is taxed only when monies are withdrawn from the policy or when the policy is surrendered, and then only to the extent that the amount paid by the insurer exceeds the owner's basis in the policy. *Id.* Third, if a taxpayer borrows against the policy, *i.e.*, uses the inside build-up as security for loans made to the taxpayer by the insurance company, the proceeds of those policy loans are not taxed. *Id.*

The last point is important because untaxed policy loan proceeds permit the insured, in a limited fashion, to utilize the inside build-up while it continues to grow tax-free within the policy. Such loans also allow a corporate policyholder to access some of the tax benefits associated with life insurance through a form of leveraging because the interest paid on policy loans is generally deductible. *See* I.R.C. § 163. The payment of premiums followed by borrowing against a life insurance policy creates the superficial appearance of a circular flow of funds, and is sometimes disparaged as "tax arbitrage." Nonetheless, such transactions create real obligations and shift real risks on both sides, and are by no means illusory.

The tax incentives for borrowing to finance life insurance premiums have been embedded in the law at least since the Internal Revenue Code of 1939, and have been exhaustively studied and regulated by Congress. Congress disallowed interest deductions derived from borrowing against single premium life insurance policies in 1942, and single premium annuity contracts in 1954. *See* I.R.C. § 264(a)(2). In 1964, it extended that disallowance to

"systematic borrowing" to purchase multiple-premium life insurance policies, but carved out several safe harbors -- including one that preserves the interest deduction if no part of the premiums is financed by borrowing in any 4 of the first 7 policy years. *See* I.R.C. § 264(a)(3), (c)(1). In 1984, it added a restrictive mathematical definition of "life insurance," designed to ensure that death benefits predominated over the purely investment characteristics of such policies. *See* I.R.C. § 7702. And in 1986, it adopted a $50,000 cap on deductible borrowing. *See* I.R.C. § 264(a)(4). That was the state of the law in 1993, the tax year at issue in this case.

2. Since 1980, Petitioners Winn-Dixie Stores, Inc. and Subsidiaries (collectively, "Winn-Dixie") have purchased life insurance policies on certain management-level employees to fund promised death, disability and retirement benefits. App. 9a. That program covered 615 employees in 1993, (App. 9a), and was "leveraged" through associated borrowing in compliance with the deductibility rules outlined above. App. 10a-11a. In 1992, Winn-Dixie was approached by a consortium of financial analysts and insurance brokers who proposed that it expand its "corporate-owned life insurance" (COLI) purchases from the limited management program into a "broad-based" pool covering all of its employees eligible for the broader Winn-Flex benefit program. App. 9a-10a. After extensive study and negotiations, Winn-Dixie ultimately decided to purchase whole life policies covering approximately 36,000 employees from AIG Life Insurance Company (AIG). App. 21a-32a.

AIG provided the life insurance coverage for the 1993 COLI Policies under a standard form of policy registered and approved as a life insurance contract by the insurance commissioner of the State of Florida. App. 29a. Policy death benefits varied with the age of the insured on the date of issue but were level over the insured's lifetime except for

increases necessary to comply with the definition of life insurance under section 7702. App. 30a-31a & n.29. The aggregate death benefits provided by the 1993 COLI Policies totaled $2.9 billion. Ex. J66.

As is typical of whole life policies, the 1993 COLI Policies also provided for an account value to be established upon the payment of premiums. That account value was credited with interest by AIG,[2] and Winn-Dixie had the right to borrow against it or withdraw it from the policies. App. 31a. Winn-Dixie borrowed against the 1993 COLI Policies for each of the first three policy years, using the loan proceeds to fund a large portion of the premiums due in those years. D100, ¶¶55, 127-30. No part of the fourth year premiums was borrowed and, had the program not been interrupted in 1997, no part of the fifth, sixth or seventh year premiums was to be borrowed. D100, ¶¶131-32; D114, 899-900. Winn-Dixie kept the 1993 COLI Policies in force from 1993 through 1997. App. 34a-39a. During the four full years when the policies were in place, Winn-Dixie paid premiums totaling $431,049,000. It financed $321,760,213 of this amount with policy loans that Winn-Dixie was required to repay, incurring interest expense on these loans of $69,774,925. Over the same period, Winn-Dixie also paid AIG $134,068,435 from the proceeds of withdrawals from the policies and $44,996,347 with funds from sources outside the policies. D100, ¶¶51, 77, 127-31.

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[2] The interest crediting rate on the *unborrowed* portion of the account value was guaranteed to be no less than 4% per annum. App. 29a. Florida statutes dictate that the interest crediting rate on the *borrowed* portion be no more than 1% below the interest rate on policy loans. Fla. Stat. Ann. § 627.4585(3)(b). Consistent with Florida law, the interest crediting rate on the borrowed portion of the account value of the 1993 COLI Policies equaled the loan interest rate of 11.06% minus a spread of 0.4%, or 10.66%. App. 29a.

Winn-Dixie's 1993 COLI Policies (like similar COLI policies owned by many large American corporations) were carefully structured to comply with Congress's repeated and specific guidance for such policies. The IRS conceded that the resolution of this case will control, or significantly influence, the outcome of subsequent decisions on the same issue for approximately 84 taxpayers that have some $2.4 billion in taxes at stake. Appellee's Motion for Leave to File an Oversized Brief at 2 (11th Cir. July 19, 2000).

3. In the Tax Court, which had jurisdiction over Winn-Dixie's petition for a redetermination of deficiency under sections 6213(a) and 7442, the IRS conceded that Winn-Dixie's COLI program complied with the Code's "4 of 7" safe harbor, its $50,000 cap on policy loans, and its definition of life insurance. App. 58a & n.48. The IRS argued, however, that based on projections the policies were not likely to produce a "pre-tax profit" – and therefore were "tax motivated, unsupported by any independent business purpose, and lack[ing in] economic substance" within the meaning of the judicially-developed "sham transaction doctrine." App. 40a.

Winn-Dixie responded that Congress has carefully studied the tax implications of leveraged life insurance for more than half a century, and that the elaborate legislative compromise embodied in sections 264 and 7702 cannot be displaced by a judicial doctrine. Winn-Dixie further argued that, even if the judicial "sham transaction doctrine" does have a role to play in this area, the IRS's persistent focus on the likelihood of a "pre-tax profit" was an inappropriate and unworkable test for determining economic substance – particularly in the context of insurance policies, which by their nature can never reliably forecast a "pre-tax profit" for the policy owner. (The "profitability" of life insurance in a purely investment sense will always depend on whether the insured dies sooner or later than actuarial predictions.)

Winn-Dixie's experts also pointed out that the death benefits and inside build-up received by Winn-Dixie were indisputably tax-free, and therefore either should have been treated as post-tax numbers or "grossed up" in any "apples-to-apples" pre-tax calculation. When that error is corrected, it becomes clear that the 1993 COLI program was profitable even without the disputed interest deductions.

The Tax Court held that characterization of a transaction as a "substantive sham" depends on "a flexible analysis that focuses on two related factors, economic substance apart from tax consequences, and business purpose." App. 43a. "Economic substance depends," the Tax Court held, "on whether, from an objective standpoint, the transaction was *likely to produce economic benefits aside from tax deductions*." App. 50a (emphasis added). Examining the projections shown to Winn-Dixie before it purchased the policies, the Tax Court concluded that an overall "pre-tax" profit for Winn-Dixie -- while concededly possible if actual mortality diverged from the actuarial projections -- was not "likely" enough to satisfy the Court's test for economic substance. App. 50a-51a. In its calculations, the Tax Court used the nominal cash-flows found in those projections, and did not gross up any of the assertedly "pre-tax" values to reflect the fact that death benefits and inside build-up are actually post-tax (*i.e.*, tax free) numbers.

The Tax Court then held that the "business purpose," prong of the sham inquiry "involves a subjective analysis of the taxpayer's intent" (App. 44a), and concluded that the 1993 COLI purchases were subjectively motivated solely by a desire to realize tax benefits. App. 51a-57a. The Tax Court distinguished *Campbell v. Cen-Tex*, 377 F.2d 688 (5th Cir. 1967), which upheld a COLI plan, on the ground that the taxpayer in that case had a "bona fide nontax business purpose" for purchasing the insurance in question: to meet

its obligations under certain deferred compensation and option plans, "as well as . . . the general objective of having insurance on its key employees and stockholders." App. 56a. The Tax Court's discussion indicates that Winn-Dixie's program was condemned as a "sham" because, in the court's opinion, Winn-Dixie had no genuine business need for the insurance. App. 51a-57a.

The Tax Court concluded that Winn-Dixie's compliance with the elaborate Code provisions governing the deductibility of policy loan interest was essentially beside the point, because "[a] transaction that lacks substance *is not recognized for Federal tax purposes*" and therefore "cannot be the basis for a deductible expense." App. 41a (emphasis added). In the Tax Court's view, the safe harbors established by section 264 were irrelevant because "[s]ection 264 does not confer the right to a deduction but simply denies, disallows, or prohibits deductions that might otherwise be allowable under [section 163]." App. 59a. The Tax Court also briefly reviewed the history of section 264 and concluded that nothing therein demonstrated a congressional intent to authorize "sham transactions." App. 61a-62a.

4. The Eleventh Circuit acknowledged that Winn-Dixie's statutory arguments "have some force," but held that it was precluded from considering those arguments by this Court's opinion in *Knetsch v. United States*, 364 U.S. 361 (1960). App. 4a. Winn-Dixie pointed out that the taxpayer in *Knetsch* relied on a tenuous negative inference from congressional inaction in a *later* statute, whereas Winn-Dixie contended that the very statutes then in effect had authorized its conduct prospectively. Winn-Dixie also noted that section 264 has been extensively amended since *Knetsch* (adding, for example, the "4 of 7" safe harbor that Winn-Dixie relies upon), and that this Court's analysis of the previous statute was therefore no longer relevant. The

Eleventh Circuit held that its hands were tied. "It may well be that *Knetsch* was then, and this is now, but . . . it is up to the Supreme Court, not us, to determine when the Court's holdings have expired." App. 5a.

Although the Eleventh Circuit affirmed the Tax Court's conclusion, its articulation of the "sham transaction" test differed in one critical detail. While the Tax Court had characterized the sham transaction test as a "flexible analysis" that "focuses on two related factors," the Eleventh Circuit articulated its previously established standard: A transaction is a "sham" unless it has *both* objective "economic substance" and a subjective "non-tax business purpose." App. 5a. The Eleventh Circuit then endorsed the Tax Court's conclusion that the program was a sham because the policies were not projected to produce a "pre-tax profit," and did not answer any other "business need of Winn-Dixie, such as indemnifying it for loss of key employees." App. 5a-6a.

REASONS FOR GRANTING THE WRIT

Several of this Court's landmark early income tax cases held that taxpayers could not defeat the intended application of the Internal Revenue Code by mislabeling transactions in a manner that elevated "form over substance." A taxpayer cannot call a transaction a lease when it is, in economic reality, a sale. This Court has, however, always been careful to emphasize that genuine transactions must be respected even if motivated solely by a desire to reduce tax liabilities. As Justice Sutherland declared in *Gregory v. Helvering*, 293 U.S. 465, 469 (1935), "[t]he legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted."

In the intervening decades, the IRS, with the aid of the Tax Court and many circuits, has nonetheless cited those

early precedents in support of an increasingly aggressive "sham transaction doctrine," which denies taxpayers the benefit of deductions concededly authorized by the text of the Code on the ground that the transaction lacked "economic substance" apart from tax benefits and/or a "non-tax business purpose." That doctrine is now employed to nullify tax consequences called for by the language of the Code, even for admittedly genuine transactions bearing genuine labels, in an unpredictable manner that fundamentally undermines the reliance interests of the nation's taxpayers. This case presents this Court with the opportunity to resolve three important doctrinal issues that have deeply divided appellate courts struggling to interpret the judicial sham transaction doctrine.

First, there is a square conflict over whether the doctrine merely represents a principle of interpretation used to construe the text of the Code, or whether it is a foundational rule of tax law that applies independent of the specific Code provisions at issue. The Eleventh Circuit here joined the latter camp, and erroneously held that this Court's interpretation of the sham transaction doctrine in *Knetsch* foreclosed it from even entertaining a textual argument with some acknowledged "force." Second, the courts of appeals are divided about the standard for determining whether a transaction has "economic substance." The "pre-tax profit" test adopted by the Tax Court and the Eleventh Circuit cannot be reconciled with this Court's decisions or the decisions of several other circuits. Third, the courts of appeals are split concerning the role of a taxpayer's motive in sham analysis. The Eleventh Circuit's holding that a transaction is a "sham" whenever the taxpayer was motivated solely by the tax savings cannot be reconciled with this Court's decisions, or with the settled law of virtually every other court of appeals. The proper formulation of this doctrine represents an issue of

exceptional importance for tax planning and adjudication, and this Court's guidance is necessary to restore the primacy of Congress's role in formulating tax policy.

I. THE ELEVENTH CIRCUIT'S DETERMINATION THAT THE SHAM TRANSACTION DOCTRINE TRUMPS THE TERMS OF I.R.C. § 264 CONFLICTS WITH THE DECISIONS OF THIS COURT AND THE D.C. CIRCUIT

The IRS's theory of this case, accepted by the Tax Court and the Eleventh Circuit, is that Winn-Dixie's practice of systematically borrowing against policy account values rendered its entire COLI program a "sham," which lacked "economic substance" or "business purpose" and is therefore void under the extra-statutory judicial "sham transaction doctrine." Even a cursory review of the Code provisions governing policy loan deductibility demonstrates, however, that Congress has already considered the precise issue that concerns the IRS in this case. Those provisions reflect an elaborate and comprehensive legislative compromise and manifestly display Congress's intent to deal with the issue of policy loan deductibility in a plenary fashion that leaves no room for supplemental judicial doctrines. The lower courts' nullification of that careful legislative compromise demonstrates the extent to which the "sham transaction doctrine" – born in this Court's early cases as a tool of statutory interpretation – has been transformed into a vehicle for judicial policymaking that is often unconcerned with and hostile to congressional intent as displayed in the plain meaning of particular Code provisions.

A. The Plain Language Of The Code Leaves No Doubt That Congress Authorized The Deductions Taken By Winn-Dixie

As the Eleventh Circuit essentially acknowledged (and the IRS conceded), the deductions at issue here satisfied the terms established by the specific provisions of the Code

governing the deductibility of interest on policy loans. Section 163(a) sets forth the broad "[g]eneral rule" that "[t]here shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness," but provides in section 163(k) that "certain amounts paid in connection with insurance . . . contracts" must satisfy section 264. Under the terms of section 264, however, amounts "paid or accrued on indebtedness incurred or continued to purchase or carry a life insurance . . . contract . . . pursuant to a plan of purchase which contemplates the systematic . . . borrowing of part or all of the increases in the cash value of such contract," are not subject to disallowance where, as here, "no part of 4 of the annual premiums due during the 7-year period . . . is paid under such plan by means of indebtedness." I.R.C. § 264(a)(3), (c)(1).

Absolutely nothing in the text of sections 163 or 264 conditions the deduction of interest for transactions that satisfy the 4 of 7 test on a further demonstration that the transaction was "likely" to generate a "pre-tax profit" or serve some other "business need." To the contrary, section 264 allows a corporate taxpayer to deduct interest on policy loans -- even if it did not satisfy the 4 of 7 test -- if it can establish instead that the debt was "incurred in connection with [a] trade or business." I.R.C. § 264(a)(3), (c)(4). Given Congress's express inclusion of a business purpose standard for deductibility under section 264(c)(4), it is patently unreasonable to infer that Congress also impliedly intended to restrict the availability of the 4 of 7 safe harbor set forth in Section 264(c)(1) to taxpayers who could demonstrate some form of business purpose for their insurance programs. *See, e.g., Brown v. Gardner*, 513 U.S. 115, 120 (1994) ("[W]here congress includes particular language in one section of a statute but omits it in another section of the same Act, it is generally presumed that Congress acts intentionally and purposely in the disparate inclusion or

exclusion.") (quoting *Russello v. United States*, 464 U.S. 16, 23 (1983)).[3]

The enactment history of section 264 further confirms what the text makes plain: Congress adopted the safe harbor at issue here to define the quantum of "economic substance" needed to qualify for interest deductions. As set forth *supra* at 2-3, the 4 of 7 test was the culmination of a series of amendments between 1942 and 1964 designed to address the proper tax treatment of interest incurred on policy loans. During the years between 1964 and 1993, the Treasury Department repeatedly reminded Congress of "the significant potential for tax arbitrage" associated with interest deductions on policy loans, and urged that the disallowance provisions should "be strengthened considerably."[4] Although bills were routinely introduced to further limit the interest deduction, Congress repeatedly declined the invitation. It did, however, adopt section 7702's restrictive definition of insurance in 1984, and a $50,000 cap on deductible borrowing in 1986, *see* I.R.C. § 264(a)(4).[5] These decisions were made with a full awareness of the potential tax advantages they perpetuated.[6] Thereafter,

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[3] In addition, similar "trade or business" language elsewhere in the Code has been interpreted to codify a form of the sham doctrine. *See, e.g.*, I.R.C. § 165(c); Tax Reform Act of 1986, Pub. L. No. 99-514, § 1808(d), 100 Stat. 2085, 2817-18 (1986); *Horn v. Commissioner*, 968 F.2d 1229, 1238 (D.C. Cir. 1992) ("Given the similarity between the statute and the sham transaction doctrine, we find it inconceivable that Congress intended that the 'sham' transaction doctrine be laid *over* the statute.").

[4] U.S. Dep't of Treas., Administration's Revenue Provisions in 1985 Budget (1984).

[5] *See* H.R. Rep. No. 98-432, pt. 2, at 1442-50 (1984), *reprinted in* 1984 U.S.C.C.A.N. 697, 1087-95; *cf.* Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 221, 98 Stat. 494, 767-76 (1984); Life Insurance Tax Act of 1983, S. 1992, 98th Cong. §§ 221, 223 (1983).

[6] *See, e.g.*, Staff of the Joint Comm. on Taxation, 98th Cong., 2d Sess., *General Explanation of the Revenue Provisions of the Deficit Reduction*

Congress and the Administration were again often reminded of the tax sheltering effects of leveraged COLI; indeed, they were even told that COLI programs could permissibly consist of small policies on large numbers of employees.[7] Congress nonetheless declined to further limit the interest deduction until 1996 -- and even then it adopted phase-out rules that expressly permitted corporate taxpayers to continue taking interest deductions on up to 20,000 policies. Health Insurance Portability & Accountability Act of 1996, Pub. L. No. 104-191, § 501(c)(2)(B)(i), 110 Stat. 1936, 2091 (1996).

When the 1993 COLI Policies were purchased, therefore, sections 163, 264, and 7702 represented a comprehensive statutory framework governing the tax benefits associated with life insurance and deductible policy loans. The elaborate legislative compromise embodied in these provisions leaves no room for a separate judicial sham inquiry -- and particularly not one that purports to address exactly the same economic and "tax arbitrage" concerns as sections 7702 and 264 themselves. Indeed, the reasons that the IRS and the courts gave for concluding that Winn-Dixie's policy loans lacked "economic substance" reduce

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Act of 1984 653 n.55 (Joint Comm. Print 1984) ("[F]or an investment-oriented purchase of traditional life insurance products, the after-tax rate of return can be boosted through the use of the policy loan provisions.").

[7] *See, e.g.*, Statement of Dennis E. Ross, Deputy Assistant Secretary (Tax Policy), Dep't of the Treas., before the Subcomm. on Select Revenue Measures of the House Comm. on Ways & Means, 100th Cong., at 12-13 (Mar. 15, 1988) ("The only change in practice is that, in order to stay below the $50,000 ceiling, businesses desiring to utilize the tax shelter are forced to purchase smaller policies on a larger number of employees."); U.S. Dep't of Treas., *Report to the Congress on the Taxation of Life Ins. Co. Prods.* 28 (Mar. 1990) ("Nothing in the law ... explicitly prevents insurers from selling to companies a large package of small cash value policies, which can be used to generate significant amounts of deductible interest, generally limited only by the number of insurable employees.").

precisely to the insight that those loans were "incurred or continued to purchase or carry a life insurance ... contract ... pursuant to a plan of purchase which contemplates the systematic direct or indirect borrowing of part or all of the increases in the cash value of such contract." I.R.C. § 264(a)(3). The text of section 264(a)(3) demonstrates beyond any doubt that Congress specifically understood and grappled with the apparent tax arbitrage created when a taxpayer seeks to deduct the interest incurred on a policy loan and then use the loan proceeds to fund part of the premiums on the policy. The only conceivable explanation for the "4 of 7" safe harbor is that Congress consciously chose to authorize the use of leverage in COLI-like transactions, within limits imposed by that test.[8]

B. The Eleventh Circuit's Reasoning Establishes The Need For This Court's Intervention

Although the Eleventh Circuit acknowledged that Winn-Dixie's statutory argument "may have some force," it held that it was precluded from accepting that argument by this Court's decision in *Knetsch*. App. 4a. The Eleventh Circuit's conclusion also conformed to its own prior precedent adopting the view that the sham doctrine represents a threshold hurdle that must be overcome before the court analyzes particular code provisions such as section

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[8] Even commentators otherwise friendly to the sham doctrine have criticized the Tax Court's opinion in this case as "simply inconsistent with common sense. Congress clearly was well aware of COLI arrangements like that entered into by Winn-Dixie and assumed that in amending the Code repeatedly over the years it was providing the rules to govern whether the tax benefits sought should be achieved." Dana L. Trier, *Beyond the Smell Test: The Role of Substantive Anti-Avoidance Rules in Addressing the Corporate Tax Shelter Problem*, 78 Taxes 62, 80-83 (Mar. 2000).

264.[9] That extra-statutory view of the sham doctrine cannot, however, be reconciled with what this Court actually held in *Gregory* and its progeny: The sham transaction doctrine is merely a principle of interpretation that must yield to specific provisions of the Code.

In *Gregory*, the taxpayer wanted to withdraw assets from a corporation she controlled but did not want to pay the taxes associated with receiving them as a dividend. At that point, section 112(g) of the Revenue Act of 1928 permitted shareholders to receive distributions tax-free in pursuance of a plan of reorganization. Sensing an opportunity, Gregory caused her corporation to transfer its assets to a new shell corporation, and then "reorganized" it out of existence and into her pocket. This Court began by stressing that the taxpayer's motive to avoid taxes was irrelevant, and stated that "if a reorganization in reality was effected within the meaning of the statute, the [taxpayer's] ulterior purpose . . . will be disregarded." *Gregory*, 293 U.S. at 469. This Court framed the issue as "whether what was done, apart from the tax motive, was the thing which the statute intended," and held that the term "plan of reorganization" in the statute "means a . . . reorganization of corporate business; and not a transfer of assets by one corporation to another in pursuance of a plan having no relation to the business of either, as plainly is the case here." *Id.* This Court concluded that "the transaction upon its face lies outside the plain intent of the statute." *Id.* at 470.

Gregory may be this Court's most important tax opinion, and is frequently cited as the source of the "sham transaction doctrine," the "substance over form" doctrine,

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[9] *See, e.g., Kirchman v. Commissioner*, 862 F.2d 1486, 1491 (11th Cir. 1989) ("[In] order for Section 108 to apply, the underlying transaction must not be a sham. . . . The analysis of whether something is a sham, then, must occur before analysis of [particular Code provisions].").

and a variety of others interposed by the IRS and the courts to defeat overly clever taxpayers. It is, however, quite carefully grounded in the language of the Code. This Court did not hold that Gregory was not entitled to rely on section 112(g) because her transaction lacked "economic substance" or "business purpose" within the meaning of some overarching doctrine; it simply held that her paper shuffling did not constitute a "reorganization" at all, because the *statute* implicitly required that the reorganization serve the purpose of an ongoing business.

This Court's opinion in *Knetsch* similarly should not be read to support a "sham transaction doctrine" cut loose from the moorings of a particular statutory context. The taxpayer in *Knetsch* ostensibly purchased ten $400,000 annuity bonds that bore interest at 2.5%, and which, upon maturity in 30 years, would begin paying him $90,171 per month for the duration of his life. To cover the $4,004,000 purchase price, Knetsch wrote a check for $4,000 and signed a $4,000,000 non-recourse note at 3.5%. He then proceeded to "borrow" back all but $1,000 of the bonds' nominal account value each year -- reducing the monthly annuity payments at maturity to a mere "pittance" of $43 per month; furthermore, those payments would not even begin until Knetsch was 90 years old. *See Knetsch*, 364 U.S. at 362-66. As in *Gregory*, this Court "put aside a finding by the District Court that Knetsch's 'only motive in purchasing these 10 bonds was to attempt to secure an interest deduction,'" and stated that "the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended." *Id.* at 365. Upon scrutiny of the arrangement, this Court held that the bonds themselves were a "fiction" and that the "loans" Knetsch received were "in reality only the rebate of a substantial part of the so-called 'interest' payments." *Id.* at 366.

Knetsch attempted to save his fictitious transaction by way of a negative inference from what section 264 of the Code *did not* say. Recall that Congress amended the Code in 1954 to prohibit explicitly the deduction of interest on any debt incurred to purchase a single premium annuity. Knetsch argued that Congress's failure to make that provision retroactive showed a congressional intent to authorize all such deductions in prior tax years. This Court held that "[u]nless that meaning plainly appears, we will not attribute it to Congress" – but nonetheless took Knetsch's argument seriously enough to scour the legislative history of section 264 for any hint "that Congress in exempting pre-1954 annuities intended to protect sham transactions." *Id.* at 369. Not surprisingly, it found none.

Two things are clear about *Knetsch*. First, that case did not hold that "economic substance" and "business purpose" are threshold requirements before any transaction can be "recognized for tax purposes." Rather, as in *Gregory*, this Court held that on the facts before it "what was done, apart from the tax motive, was [not] the thing which the statute intended." Second, *Knetsch* is not this case. Winn-Dixie's argument has never been that its deductions were authorized by an inference from subsequent congressional inaction – but instead that the complex and comprehensive statutory scheme already in place in 1993 reveals a congressional intent to occupy the field *prospectively*. That inference is reasonable and common in statutory interpretation cases; and yet the Tax Court and the Eleventh Circuit gave it even less serious consideration than this Court gave to the far more tenuous inference suggested by Knetsch. This Court certainly did not hold in *Knetsch* that a congressional intent to define the quantum of economic substance necessary for a particular transaction should never be inferred from the language and structure of the Code, or even that such an inference should be drawn

only in extraordinary circumstances. The fact that the Tax Court and the Eleventh Circuit (as well as other circuits) felt duty bound to read *Knetsch* that way highlights the necessity for this Court's intervention.

C. The Holding Of The Eleventh Circuit Squarely Conflicts With The Settled Law Of The D.C. Circuit

The Tax Court and the Eleventh Circuit are not alone in viewing the sham transaction doctrine as a threshold question that applies independent of the Code. Several courts of appeals, including the Second, Third, and Eleventh Circuits, hold that a transaction lacking "economic substance" and/or a "business purpose" is not recognized for tax purposes at all, and that a reviewing court therefore need not even interpret the particular language of the Code if those preconditions are not satisfied. The D.C. Circuit has held, in contrast, that the language or structure of particular Code provisions may reflect a congressional intent to reformulate the sham inquiry – or to displace it altogether. Had this case arisen in the D.C. Circuit, it is clear from the court's decision in *Horn v. Commissioner*, 968 F.2d 1229 (1992), that the unambiguous text of the Code would have been given effect.

A brief summary of the factual context that preceded the decision in *Horn* serves to highlight the recurring importance of the sham doctrine in the resolution of tax controversies. In the 1970s, thousands of taxpayers purported to engage in a series of complex options "straddle" transactions in the London commodities markets in order to exploit several anomalies in the way the IRS recognized gain or loss on options. The IRS considered these transactions "shams," and disallowed all of the deductions. By 1986, Congress had amended the statute to provide that the losses "*shall be allowed*" if entered into either "for profit" or "in a trade or business." Congress also

provided that "any loss incurred by a commodities dealer in the trading of commodities *shall be treated* as a loss incurred in a trade or business." *See* Tax Reform Act of 1986, Pub. L. No. 99-514, § 1808(d), 100 Stat. 2085, 2817-18 (1986) (hereinafter "section 108") (emphasis added).

The IRS nevertheless continued to invoke the "sham transaction" doctrine to disallow the losses incurred by commodities dealers -- reasoning, as in this case, that the sham doctrine applied prior to and independent of the statute. Even more disturbing, the Tax Court and the courts of appeals for the Second, Third and Ninth Circuits agreed.[10] The Third Circuit expressed the rationale most clearly: "Per *Gregory v. Helvering*, . . . it is settled federal tax law that for transactions to be recognized for tax purposes they must have economic substance. Therefore, economic substance is a *prerequisite* to the application of any Code provisions allowing deductions, including section 108." *Lerman*, 939 F.2d at 52.

The D.C. Circuit held, however, that the IRS's position "takes the sham doctrine too far" and "is plainly and simply wrong." *Horn*, 968 F.2d at 1231. After reviewing this Court's decisions in *Gregory*, *Knetsch*, and other "sham" cases, the D.C. Circuit pronounced itself "at a loss to understand the Commissioner's suggestion, adopted by several courts, that the sham transaction doctrine applies independently of section 108." *Id.* at 1238. "Although useful in determining congressional intent and in avoiding results unintended by tax code provisions," the D.C. Circuit wrote,

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[10] *See Fox v. Commissioner*, 56 T.C.M. (CCH) 863, 866-868 (1988); *Gardner v. Commissioner*, 954 F.2d 836 (2d Cir.) (per curiam), *cert. denied sub nom. Falk v. Commissioner*, 504 U.S. 910 (1992); *Lerman v. Commissioner*, 939 F.2d 44 (3d Cir.), *cert. denied*, 502 U.S. 984 (1991); *Cook v. Commissioner*, 941 F.2d 734 (9th Cir.), *cert. denied*, 502 U.S. 857 (1991).

the sham doctrine "cannot trump the plainly expressed intent of the legislature." *Id.* at 1231.

Notwithstanding the absence of any explicit declaration that Congress intended to protect "sham transactions" as such, the D.C. Circuit concluded that the language and structure of section 108 clearly revealed an intent to preempt the doctrine with a comprehensive statutory solution. The D.C. Circuit first noted that the plain language of the statute appeared to allow all losses by commodities dealers. "This case requires us to decide whether the statute means what it says," the court wrote. "We hold that it does." *Id.* at 1234. The D.C. Circuit further explained that the IRS's theory would leave the commodities dealer presumption in section 108(b) without any independent statutory purpose (*id.*), and that the statutory safe harbor for transactions entered into "for profit" or "in a trade or business" was clearly intended to codify something like the "sham" analysis. *Id.* at 1238. "Given the similarity between the statute and the sham transaction doctrine, we find it inconceivable that Congress intended that the 'sham' transaction doctrine be laid *over* the statute." *Id.* Finally, the D.C. Circuit rejected the Commissioner's alternative theory that a sham transaction should not be regarded as producing a genuine "loss" for tax purposes at all. The Court held that the commodities dealers suffered a "loss" within the plain meaning of that term. *Id.* at 1239.

The D.C. Circuit's reasoning in *Horn* underscores the close similarity between that case and this one. As in *Horn*, the plain language of section 264 reveals careful consideration by Congress of the precise issue that led the IRS to label Winn-Dixie's COLI program a "sham." As in *Horn*, Congress specifically created a statutory safe harbor for transactions "in connection with [the taxpayer's] trade or business," which is best read as partially codifying the

sham doctrine. I.R.C. § 264(c)(4). The "4 of 7" test in section 264(c)(1) and the mathematical definition of insurance in section 7702 are also clearly intended to codify the concept of "economic substance" in the life insurance context; indeed, there is no other sensible way to understand those provisions. *Horn* is on all fours with the present situation; there can be no doubt that the D.C. Circuit would have decided this case in Winn-Dixie's favor.

II. THE ELEVENTH CIRCUIT'S PRE-TAX PROFIT TEST FOR ECONOMIC SUBSTANCE CONFLICTS WITH PRECEDENTS OF THIS COURT AND OTHER CIRCUITS

This Court has never held that a transaction lacks "economic substance," or that it may be disregarded for tax purposes, simply because the transaction was not projected to produce a "pre-tax profit." Indeed, this Court has emphatically rejected the suggestion that taxpayers are required to make economic decisions on a pretax basis, as if the Tax Code did not exist. "The fact that favorable tax consequences were taken into account by [the taxpayer] on entering into the transaction is no reason for disallowing those consequences. We cannot ignore the reality that the tax laws affect the shape of nearly every business transaction." *Frank Lyon Co. v. United States*, 435 U.S. 561, 580 (1978) (footnote omitted). As the earlier discussion of *Gregory* and *Knetsch* makes clear, this Court has always framed the issue instead as simply "whether what was done, apart from the tax motive, was the thing which the statute intended."

This Court's 1978 decision in *Frank Lyon* appears to have inspired the "two-pronged" sham transaction test now applied by many lower courts.[11] That decision makes it

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[11] *See Rice's Toyota World, Inc. v. Commissioner*, 752 F.2d 89, 91 (4th Cir. 1985) ("The Tax Court read *Frank Lyon* ... to mandate a two-

clear, however, that a real transaction with meaningful economic consequences is not a sham, whether or not a pre-tax profit was likely. In *Frank Lyon*, the taxpayer was on the board of a bank that could not, for regulatory reasons, be the owner of a new building that it wanted to construct. Lyon therefore agreed to lease the property from the bank, build the building (using $500,000 of his own money and a third-party mortgage), and then lease it back to the bank. The bank's lease payments to Lyon exactly covered Lyon's mortgage payments, and the bank retained an option to purchase the building at certain intervals for the balance of the mortgage plus a fixed sum equal to Lyon's $500,000 down payment and 6% compound interest on that sum. The IRS sought to recharacterize the transaction as a 6% loan from Lyon to the bank, largely because the bank's option removed any financial upside to Lyon from his ownership of the building. *Frank Lyon*, 435 U.S. at 574.

In holding that Lyon's ownership was nevertheless "not a simple sham to be ignored," *id.* at 580, this Court focused not on any likely financial upside from that status, but rather on the "significant and genuine attributes of the traditional lessor status" that Lyon had retained. *Id.* at 584. Chief among those attributes were a number of "real and substantial risk[s]" of ownership that Lyon had assumed. *Id.* at 577. Those risks included Lyons' liability on the recourse mortgage, and the chance that if the property depreciated the bank would choose not to extend the building lease -- leaving Lyon with the mortgage and a substantial continuing liability on the ground lease. *Id.* at 583. Lyon's ownership of the building therefore did "'appreciably affect his beneficial interest,'" *Knetsch*, 364

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pronged inquiry to determine whether a transaction is, for tax purposes, a sham.").

U.S. at 366 (citation omitted), even if it held out no prospect of a financial upside. This Court held that it was not a sham.

In conflict with the holding in *Frank Lyon*, the Tax Court and the Eleventh Circuit -- as well as the Fourth and Eighth circuits -- have equated economic substance with the likelihood of pre-tax profit.[12] Several other circuits, however, recognize that when the sham doctrine applies, the issue is whether the transaction resulted in any genuine change in economic position and bore a genuine label, without regard for the likelihood of a pre-tax profit. In circuits where those principles are applied (including at least the First, Seventh, and Ninth Circuits), Winn-Dixie would have prevailed.

The difference is illustrated by *Maysteel Products, Inc. v. Commissioner*, 287 F.2d 429 (7th Cir. 1961), and *Fabreeka Products Co. v. Commissioner*, 294 F.2d 876 (1st Cir. 1961), in which the First and Seventh Circuits held that plainly tax-motivated bond purchases were not "shams" even though they could not be justified by any pre-tax profit potential.[13] The Seventh Circuit stressed that "[t]he motivation involved does not destroy the . . . genuineness of

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[12] *See, e.g., Rice's Toyota World*, 752 F.2d at 91 (4th Cir.) ("To treat a transaction as a sham, the court must find that the taxpayer was motivated by no business purposes other than obtaining tax benefits . . . , and that the transaction has no economic substance because no reasonable possibility of a profit exists."); *Shriver v. Commissioner*, 899 F.2d 724, 726 (8th Cir. 1990) (transaction lacks economic substance if there was no "'reasonable possibility of profit . . . apart from tax benefits.'") (citation omitted).

[13] *See Maysteel*, 287 F.2d at 431 (noting Tax Court finding that the transaction was "entered into by petitioner with no intention that such transactions should produce a business profit, gain or benefit other than that which might result from a deduction for bond premium amortization") (Schnackenberg, J., dissenting); *Fabreeka*, 294 F.2d at 877-78 (acknowledging that taxpayers' sole motive was tax avoidance, and could not be justified by "investment motives").

the transaction[s]," which were "real in every sense," and exposed the taxpayer to "all of the usual risks involved in such transactions ... risks and obligations beyond its control." *Maysteel*, 287 F.2d at 431. Similarly, the First Circuit affirmed the finding that "the sole motive" for the transaction was the tax savings, but upheld the deductions nonetheless: "[T]he taxpayers ... made actual 'investments' in the ordinary sense of the word. They purchased the bonds ... [and] [d]uring the necessary holding period they incurred fully all of the risks of ownership ...." *Fabreeka*, 294 F.2d at 878. In light of those genuine risks and obligations, both courts held that the transactions were not "shams" merely because their profitability derived from tax benefits.[14]

The Ninth Circuit similarly rejected "pre-tax profitability" as the test of economic substance in *Sacks v. Commissioner*, 69 F.3d 982 (9th Cir. 1995). The taxpayer in *Sacks* purchased solar water heaters from a promoter, paying partly in cash and partly in promissory notes, and then leased them back. The promoter in turn leased the devices to homeowners. Sacks claimed depreciation deductions, as well as considerable tax credits that Congress had created to encourage investment in the development of alternative energy sources. Concluding that the investment would not have been profitable on a "pre-tax" basis, the IRS and the Tax Court disregarded it as a "sham."

The Ninth Circuit explicitly rejected the Tax Court's pre-tax profit test as inconsistent with this Court's opinion

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[14] *See also, e.g., Northern Indiana Pub. Serv. Co. v. Commissioner*, 115 F.3d 506, 512 (7th Cir. 1997) ("*NIPSCO*") (*Gregory* and its progeny "do not allow the Commissioner to disregard economic transactions ... which result in actual, non-tax-related changes in economic position"); *Yosha v. Commissioner*, 861 F.2d 494, 501 (7th Cir. 1988) ("The lack of substance lies in the fact that the investor had *zero* prospect of gain or loss.") (emphasis added).

in *Frank Lyon*. "Mr. Sacks' investment did not become a sham just because its profitability was based on after-tax instead of pre-tax projections," the court wrote; "[i]t is undisputed that he stood to make money on an after-tax basis," and "'[t]he fact that favorable tax consequences were taken into account ... is no reason for disallowing those consequences.'" 69 F.3d at 991 (quoting *Frank Lyon*, 435 U.S. at 580) (omission in original).

The Ninth Circuit also pointed out the absurdity of the Tax Court's "pre-tax profit" test as a matter of tax policy. Congress had intentionally created the tax benefits sought by Mr. Sacks in order to foster the development of alternative energy sources. "If the government treats tax-advantaged transactions as shams unless they make economic sense on a pre-tax basis, then it takes away with the executive hand what it gives with the legislative." *Id.* at 992.[15] The point, of course, is that favorable tax treatment in the Code is "intended to induce investments which otherwise would not have been made." *Id.* But "[i]f the Commissioner were permitted to deny tax benefits when the investments would not have been made but for the tax advantages, then only those investments would be made which would have been made without the Congressional decision to favor them." *Id.* A pre-tax profit test for economic substance therefore "use[s] the reason Congress

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[15] The decision in this case turns congressional intent on its head in exactly the same way. By refusing to account for the tax free nature of death benefits and inside build-up in their "pre-tax profit" calculations, the courts effectively held that Winn-Dixie could not legitimately consider those benefits when comparing insurance to alternative investments that would have produced taxable income – thus nullifying the incentives that Congress obviously intended. *See also Compaq v. Commissioner*, No. 00-60648, 2001 WL 1662035, at *6 (5th Cir. Dec. 28, 2001) ("To be consistent, the analysis should either count all tax law effects or not count any of them.").

created the tax benefits as a ground for denying them." *Id.*[16]

There can be no doubt that Winn-Dixie's 1993 COLI Policies had economic substance, correctly understood. Like the taxpayers in *Maysteel*, *Fabreeka*, and *Sacks*, Winn-Dixie purchased real insurance policies that had substantial consequences for its real-world economic position, completely apart from tax effects. Those policies were approved for sale as life insurance by the insurance commissioner of the State of Florida, and the IRS concedes that they satisfied the rigorous standards for treatment as such under section 7702. The policies provided very substantial death benefits and -- in dramatic contrast to the transaction disregarded by this Court in *Knetsch* -- those benefits were never reduced to a relative "pittance" by loans against the policies. *Knetsch*, 364 U.S. at 366. To the contrary, death benefits under the policies dwarfed policy loans at all times; at the beginning of policy year four (March 1, 1996), for example, Winn-Dixie had a potential policy death benefit of $3,225,845,197, exceeding accumulated policy loans ($320,958,141.16) by more than ten

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[16] As numerous commentators have pointed out, the theoretical difficulties with a "pre-tax profit" test go far beyond the obvious policy issue identified by *Sacks*. The very notion of a "pre-tax profit" is circular, because capital markets inevitably take expected tax benefits into account when setting relative prices. *See generally* Alvin C. Warren, Jr., *The Requirement of Economic Profit in Tax-Motivated Transactions*, 59 Taxes 985, 987-91 (Dec. 1981). And the presence or absence of an economic profit will usually depend on the amount of equity invested in a transaction, not on whether it has genuine economic substance. Almost any "complicated way of investing cash" will produce a profit, but may be illusory in the sense of leaving the taxpayer's economic situation completely unchanged. By contrast, many transactions with obvious substance are not likely to produce a profit. *See* David P. Hariton, *Sorting Out the Tangle of Economic Substance*, 52 Tax Lawyer 235, 235-36 (Winter 1999). A "naked position in commodities" is one example, *id.*; simple life insurance is another.

to one. Ex. J272, pA9598. The transaction "genuinely shifted" the risk that Winn-Dixie's future mortality experience would not precisely track the insurance company's projections. *Sacks*, 69 F.3d at 988.[17]

Winn-Dixie also had the right to be paid interest by AIG on policy account values at a guaranteed rate of at least 4%, regardless of future changes in prevailing rates. Ex. J63, ppA1997, A2003. It was entitled to borrow on the sole security of those account values, at fixed rates and without transaction costs – whether or not the current business climate or AIG's own financial condition would otherwise warrant the extension of credit on such terms. D100, ¶¶96-97, 110; Ex. J63, pA2004.[18] Winn-Dixie was also exposed to the risk that AIG would become insolvent after receiving Winn-Dixie's premium payments, but before paying out all of the death benefits to which it was entitled. *See Frank Lyon*, 435 U.S. at 583 (noting "the risk, borne by Lyon, that Worthen might default or fail"). These and many other genuine economic consequences of Winn-Dixie's COLI polices establish that Winn-Dixie and AIG each assumed real "risks and obligations beyond its control," *Maysteel*, 287 F.2d at 431, and that those transactions would not have been

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[17] The Tax Court was convinced that such a divergence was highly unlikely (App. 50a), but in the context of numbers as large as these even a small risk must be regarded as significant. *See Fabreeka*, 294 F.2d at 878 (real but "negligible" risk sufficient to confer substance). In any event, the Tax Court's skepticism is belied by the fact that the parties bothered to negotiate a complex series of provisions which effectively limited AIG's potential gain from such a divergence (although not Winn-Dixie's) to 2%. App. 28a.

[18] Importantly, these loans were netted against the account values and appeared as net assets (not liabilities) on Winn-Dixie's financial reports. D106, p110-111. *See generally* Offsetting of Amounts Related to Certain Contracts, FASB Interpretation No. 39 (1992). Thus, Winn-Dixie could borrow without impairing its assets or credit beyond the policies themselves.

disregarded as shams in the First, Seventh, or Ninth Circuits.

III. THE ELEVENTH CIRCUIT'S REQUIREMENT THAT A TRANSACTION MUST ALWAYS BE MOTIVATED BY A NON-TAX "BUSINESS NEED" CONFLICTS WITH THE DECISIONS OF THIS COURT AND OTHER COURTS OF APPEALS

This case also presents this Court with a needed opportunity to clarify the role of taxpayer motivation in sham analysis. The Eleventh Circuit placed great weight on the view that Winn-Dixie's program was not motivated by any "business need" to insure the lives of the covered employees, and reaffirmed its rule that a transaction is a sham unless it has both objective "economic substance" *and* a subjective "business purpose" other than the reduction of tax. App. 5a-6a. That holding is flatly inconsistent with this Court's cases and with the settled law of other circuits.

Clearly, repeatedly, and in the very cases usually cited as creating the "sham transaction doctrine," this Court has warned the IRS and the lower courts that a subjective motive to reduce taxes by legal means may not be held against a taxpayer. In both *Gregory* and *Knetsch*, this Court explicitly "put aside" as irrelevant district court findings that the taxpayer's sole motive was to reduce taxes. *Gregory*, 293 U.S. at 469; *Knetsch*, 364 U.S. at 365 (same); *see also Frank Lyon*, 435 U.S. at 580.

The Eleventh Circuit's rule is also in direct conflict with the Second, Fourth, and D.C. Circuits, which have all held that *either* economic substance or business purpose will save a transaction from the sham label.[19] The Eleventh Circuit

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[19] *See DeMartino v. Commissioner*, 862 F.2d 400, 406 (2d Cir. 1988); *Rice's Toyota World*, 752 F.2d at 91-92 (4th Cir.); *Horn*, 968 F.2d at 1237 (D.C. Cir.).

has acknowledged this conflict, and persists in its contrary view. *See UPS v. Commissioner*, 254 F.3d 1014, 1018 n.2 (11th Cir. 2001). The Eleventh Circuit's rule also conflicts with the rule adopted by the Third, Sixth, Ninth, and Tenth Circuits, which provides that the sham doctrine cannot be reduced to a two-prong test, but instead requires a holistic inquiry into the substance and purpose of the transaction.[20]

CONCLUSION

The legal standards governing the "sham transaction" doctrine represent an issue of exceptional importance to tax planning and adjudication, and this Court's intervention has now become necessary. The courts of appeals are in hopeless disarray regarding the basic content of the sham transaction doctrine. They disagree about what "economic substance" means, and how much is required.[21] They disagree about the relevance of the taxpayer's subjective motive. They even disagree about whether the characterization of a transaction as a "sham" is a question of fact or of law.[22]

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[20] *ACM P'ship v. Commissioner*, 157 F.3d 231, 247 (3d Cir. 1998), *cert. denied*, 526 U.S. 1017 (1999); *Rose v. Commissioner*, 868 F.2d 851 (6th Cir. 1989); *Sochin v. Commissioner*, 843 F.2d 351, 354 (9th Cir.), *cert. denied*, 488 U.S. 824 (1988); *James v. Commissioner*, 899 F.2d 905 (10th Cir. 1990).

[21] Some courts have discounted projected cash flows to net present value, which has the obvious consequence of requiring that the transaction generate not merely some net profit, but a compounded net profit in excess of whatever discount rate is applied. *Compare ACM*, 157 F.3d at 259, *with Sacks*, 69 F.3d at 991, *and Rice's Toyota World, Inc. v. Commissioner*, 81 T.C. 184, 203 n.17 (1983), *and Hilton v. Commissioner*, 671 F.2d 316 (9th Cir.), *cert. denied*, 459 U.S. 907 (1982).

[22] *Compare James*, 899 F.2d at 908–09 (10th Cir.) (question of law, reviewed de novo), *and Compaq*, 2001 WL 1662035, at *2 (same), *with Ferguson v. Commissioner*, 29 F.3d 98, 101 (2d Cir. 1994) (question of fact, reviewed for clear error), *and ACM*, 157 F.3d at 245 (3d Cir.) (same), *and Hunt v. Commissioner*, 938 F.2d 466, 472 (4th Cir. 1991) (same), *and*

For these and other reasons, judges and commentators have noted that the doctrine as currently applied often amounts to little more than an arbitrary and unpredictable "smell test." *ACM*, 157 F.3d at 265 (McKee, J., dissenting).[23] The continuing confusion described above, as well as the Eleventh Circuit's conclusion that *Knetsch* compels the outcome reached below, illustrate that the courts of appeals will not succeed in bringing order to this chaos without this Court's intervention. For the reasons set forth, the petition for certiorari should be granted.

Respectfully submitted,

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Lukens v. Commissioner, 945 F.2d 92, 97 (5th Cir. 1991) (same), *and NIPSCO*, 115 F.3d at 510 (7th Cir.) (same).

[23] *See, e.g.*, Mark P. Gergen, *The Common Knowledge of Tax Abuse*, 54 SMU L. Rev. 131, 137-38 (2001); Joseph Isenbergh, *Musings on Form and Substance in Taxation*, 49 U. Chi. L. Rev. 859, 863-84 (1982); *supra* n.16.

APPENDIX

TABLE OF CONTENTS

I. OPINIONS AND ORDERS BELOW

Winn-Dixie Stores, Inc. v. Commissioner,
No. 00-11828-JJ, 254 F.3d 1313
(11th Cir. June 28, 2001).....1a

Winn-Dixie Stores, Inc. v. Commissioner,
No. 5382-97, 113 T.C. 254 (Oct. 19, 1999).....7a

Winn-Dixie Stores, Inc. v. Commissioner,
No.00-11828-JJ (11th Cir. Sept. 28, 2001).....64a

II. STATUTORY PROVISIONS

I.R.C. § 163 (1993).....66a

I.R.C. § 264 (1993).....92a

I.R.C. § 7702 (1993).....95a

Health Insurance Portability & Accountability
Act of 1996, Pub. L. No. 104-191, § 501, 110 Stat. 1936,
2090-93 (1996).....109a

APPENDIX A

UNITED STATES COURT OF APPEALS FOR THE ELEVENTH CIRCUIT

No. 00-11828.

WINN-DIXIE STORES, INC. AND SUBSIDIARIES,

PETITIONER-APPELLANT,

V.

COMMISSIONER OF INTERNAL REVENUE,

RESPONDENT-APPELLEE.

APPEAL FROM A DECISION OF THE UNITED STATES TAX COURT

Before
WILSON, Circuit Judge,
COX, Circuit Judge,
RYSKAMP, District Judge

JUNE 28, 2001, DECIDED

JUNE 28, 2001, FILED

PER CURIAM:

Winn-Dixie Stores, Inc. appeals the tax court's judgment resting on the conclusion that Winn-Dixie was not entitled to

deduct interest and fees incurred in borrowing against insurance policies that it owned on the lives of more than 36,000 Winn-Dixie employees. We affirm.

BACKGROUND

In summary, the tax court found the following facts: In 1993, Winn-Dixie embarked on a broad-based company-owned life-insurance (COLI) program whose sole purpose, as shown by contemporary memoranda, was to satisfy Winn-Dixie's "appetite" for interest deductions. Under the program, Winn-Dixie purchased whole life insurance policies on almost all of its full-time employees, who numbered in the tens of thousands. Winn-Dixie was the sole beneficiary of the policies. Winn-Dixie would borrow against those policies' account value at an interest rate of over 11%. The high interest and the administrative fees that came with the program outweighed the net cash surrender value and benefits paid on the policies, with the result that in pretax terms Winn-Dixie lost money on the program. The deductibility of the interest and fees posttax, however, yielded a benefit projected to reach into the billions of dollars over 60 years. Winn-Dixie participated until 1997, when a change in tax law jeopardized this tax arbitrage, and it eased its way out.

The IRS determined a deficiency because of the interest and fee deductions taken in Winn-Dixie's 1993 tax year. Winn-Dixie challenged the determination before the tax court. The tax court rejected Winn-Dixie's assertions that the COLI program had a business purpose, or that Congress had expressly authorized its tax benefits. *See Winn-Dixie Stores, Inc. v. Comm'r*, 113 T.C. 254 (1999). The court held that the loans against the policies were substantive shams, and that Winn-Dixie was therefore not entitled to deductions for the interest and fees paid for the loans. Winn-Dixie appeals.

Winn-Dixie's two core arguments here are the same as those it made to the tax court. The first is that Congress, through the Internal Revenue Code, explicitly authorized the deduction of interest and fees incurred in certain borrowing against whole life-insurance policies' account value. This explicit permission, Winn-Dixie says, makes application of the sham-transaction doctrine inappropriate. In the alternative, Winn-Dixie argues that even if the sham-transaction doctrine properly applies here, the tax court misinterpreted the economic-substance and business-purpose prongs of that doctrine and thus "shammed" a transaction that was due respect. Winn-Dixie does not dispute any finding of historical fact; these issues are exclusively ones of law, and our consideration of them is accordingly de novo. *United Parcel Serv. of Am., Inc. v. Comm'r*, ____ F.3d_____, _____ (11th Cir. 2001).

DISCUSSION

Winn-Dixie starts its argument by invoking the special treatment afforded life insurance contracts (as defined in *I.R.C. § 7702*) in general, whose benefits are generally untaxed and whose appreciation is tax-deferred. *See* I.R.C. §§ 101(a)(1), 72(e)[1]. That treatment extends to loans made against a policy, whose interest (unlike most other (nonconsumer) interest, I.R.C. § 163(a)) is generally not deductible. *See* I.R.C. § 264(a)(3). But there is an exception (called the 4-of-7 exception) to this prohibition on deducting interest on policy loans; the prohibition does not apply if no part of the annual premium is financed by a policy loan in four of the first seven years. *See* I.R.C. § 264(c)(1). Winn-Dixie's loans

---

[1] We follow Winn-Dixie's practice of consistently citing to the statutes in effect during the pertinent tax year, 1993. The use of the present tense to describe 1993 provisions is for convenience and does not imply that they are still in effect.

fell within the 4-of-7 exception, all agree. Because they qualify for the exception, and because the loans are within the specially treated world of life insurance that has obviously been the subject of congressional attention, Winn-Dixie contends, there is no room for application of the sham-transaction doctrine.

This argument may have some force, but it runs into binding precedent. The Supreme Court was faced with a materially similar argument decades ago by a taxpayer who sought to deduct interest payments on loans taken against an annuity contract. *See Knetsch v. United States*, 364 U.S. 361, 363, 81 S. Ct. 132, 133-34, 5 L. Ed. 2d 128 (1960). Because, as here, the annuity contract was obviously being used as a tax shelter, and as used offered the taxpayer no financial benefit other than its tax consequences, the Court held that the indebtedness was not bona fide, and the interest not deductible under § 163(a). *See id.* at 366, 81 S. Ct. at 135. Along the way, the Court rejected an argument based on § 264 that is at least a cousin of Winn-Dixie's present contention. Knetsch argued that Congress's failure to close a loophole in § 264 (that section's prohibition of deductions on indebtedness to purchase life-insurance policies did not extend to annuities until 1954, the year after the tax year in question) equated to blessing the loophole. The Court declined to attribute such an intention to Congress, because that would "exalt artifice above reality." *Id.* at 367, 81 S. Ct. at 136 (quoting *Gregory v. Helvering*, 293 U.S. 465, 470 (1935)). *Knetsch* holds, therefore, that the sham-transaction doctrine does apply to indebtedness that generates interest sought to be deducted under § 163(a), even if the interest deduction is not yet prohibited by § 264. That is a holding that we have followed in this circuit. *See Campbell v. Cen-Tex, Inc.*, 377 F.2d 688, 692 (5th Cir. 1967) (applying the sham-transaction doctrine to deduction of interest on insurance-policy loans, but finding economic substance).

Winn-Dixie tries to get around *Knetsch* with the argument that we have 33 more years (as of 1993) of congressional regulation of interest deductions in this context, and that 33-year history shows that Congress does not want courts to look behind facial compliance with, for instance, the 4-of-7 exception. It may well be that *Knetsch* was then, and this is now, but we are not the court to make that call. *Knetsch*'s holding is at best undermined by congressional action (or inaction) in the intervening decades, and it is up to the Supreme Court, not us, to determine when the Court's holdings have expired. *See Agostini v. Felton*, 521 U.S. 203, 237, 117 S. Ct. 1997, 2017, 138 L. Ed. 2d 391 (1997). We therefore must conclude that the tax court properly examined the transaction under the sham-transaction doctrine.

That doctrine provides that a transaction is not entitled to tax respect if it lacks economic effects or substance other than the generation of tax benefits, or if the transaction serves no business purpose. *See United Parcel Serv.*, ___ F.3d ____at _____; *Kirchman v. Comm'r*, 862 F.2d 1486, 1492 (11th Cir. 1989). The doctrine has few bright lines, but "it is clear that transactions whose sole function is to produce tax deductions are substantive shams." *Kirchman*, 862 F.2d at 1492. That was, as we read the tax court's opinion, the rule the tax court followed. Nor did the court misapply the rule in concluding that the broad-based COLI program had no "function" other than generating interest deductions.

The tax court found, without challenge here,[2] that the program could never generate a pretax profit. That was

---

[2] Winn-Dixie disclaims any intent to challenge the tax court's fact findings and asks for a de novo standard of review. (Blue Br. at 13, 39.) We therefore read Winn-Dixie's arguable challenges to this finding of historical fact as disagreement with the rule stated in *Kirchman*. That challenge is, of course, unavailing.

what Winn-Dixie thought as it set up the program, and it is the most plausible explanation for Winn-Dixie's withdrawal after the 1996 changes to the tax law threatened the tax benefits Winn-Dixie was receiving. No finding of the tax court suggests, furthermore, that the broad-based COLI program answered any business need of Winn-Dixie, such as indemnifying it for loss of key employees. Nor could it have been conceived as an employee benefit, because Winn-Dixie was the beneficiary of the policies. Under *Kirchman*, therefore, the broad-based COLI program lacked sufficient economic substance to be respected for tax purposes, and the tax court did not err in so concluding.

CONCLUSION

For the foregoing reasons, the judgment of the tax court is affirmed.

AFFIRMED.

UNITED STATES TAX COURT

No. 5382-97

WINN-DIXIE STORES, INC. AND SUBSIDIARIES,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
RESPONDENT.

FILED OCTOBER 19, 1999

RUWE, *Judge*: Respondent determined a deficiency of $1,599,176 in petitioner's Federal income tax for its tax year ending June 30, 1993. After concessions, the issue is whether deductions petitioner claimed for policy loan interest and administrative fees associated with certain of petitioner's corporate-owned life insurance (COLI) policies are deductible.

Unless otherwise indicated, all section references are to the Internal Revenue Code in effect for the year in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulations of facts are incorporated herein by this reference. At the time the petition was filed, petitioner was a

Florida corporation with its principal office in Jacksonville, Florida.

Petitioner was founded in the 1920's, and its stock is publicly traded on the New York Stock Exchange. Petitioner is a major food retailer made up of self-service food stores which sell groceries, meats, seafood, fresh produce, deli/bakery, pharmaceuticals, and general merchandise items. As of June 30, 1993, petitioner had 1,165 stores in 14 States and the Bahama Islands.

Petitioner is an accrual basis taxpayer, which has adopted a 52-53 week fiscal year ending on the last Wednesday in June. Petitioner filed a consolidated corporate Federal income tax return for its fiscal year ending June 30, 1993.

As of June 30, 1993, petitioner employed approximately 36,000 full-time and 69,000 part-time employees. Since 1988, all full-time employees who completed 3 months of continuous service have been eligible for a flexible benefits program called "Winn-Flex". Under Winn-Flex, employees were furnished certain benefits that they received automatically and certain optional benefits among which they could choose. Employees automatically received life insur[illegible] and accident and sickness coverage. The optional b[illegible]efits included a medical plan, dental coverage, vision coverage, supplemental associate life insurance, long-term disability and two flexible spending accounts for health care and dependent care. Petitioner self-insured the medical and life insurance benefits under Winn-Flex while the remaining benefits were insured through third parties.

The life insurance coverage provided by the company under the core Winn-Flex benefit program was in effect only while a worker was a full-time employee. Petitioner provided no postretirement benefits to its employees under

Winn-Flex. Early retirees covered by the Winn-Flex plan had the option of continued coverage under a separate insurance pool not paid for by petitioner.

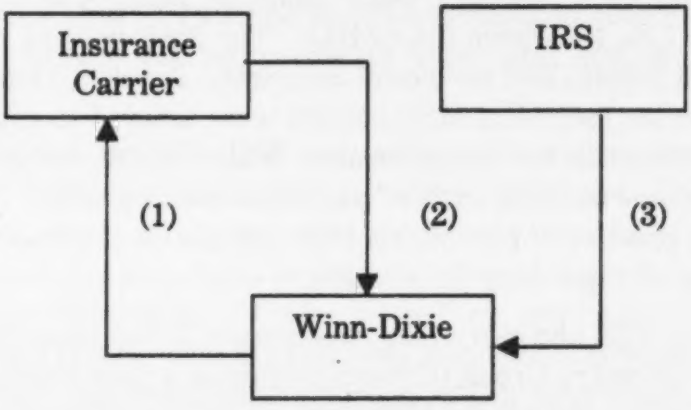
Since 1980, petitioner has also maintained a program to provide death, disability, and retirement benefits to a limited number of full-time management level employees. This program was known as the "Management Security Program" (MSP). During the fiscal year ending in 1993, 615 of petitioner's employees were covered under the MSP. In order to provide funds for specific benefits for each manager, petitioner purchased flexible premium adjustable life insurance policies on each manager (MSP policies) from American Heritage Life Insurance Co. (AHL). The MSP policies are individual policies and not group contracts. The death benefits under the individual MSP policies were tailored to cover petitioner's costs for preretirement deaths of the covered individual and to cover costs of postretirement benefits. Petitioner's practice of purchasing MSP policies on the lives of its managers began long before 1993.

During 1992 and early 1993, Wiedemann & Johnson (WJ) and The Coventry Group (Coventry) formed a joint venture (WJ/Coventry) and approached petitioner with a proposal for the purchase by petitioner of individual excess interest life insurance policies on the lives of petitioner's employees. AIG Life Insurance Company (AIG) was to be the underwriter for the proposed policies. In a letter dated January 12, 1993, Mr. Alan Buerger, chairman of Coventry, confirmed a meeting on January 14, 1993, with Mr. Richard D. McCook, petitioner's financial vice president. Included with the letter was a memorandum from Mr. Buerger and Mr. Bruce Hlavacek, chairman and chief executive officer of WJ, proposing that petitioner purchase a "broad-based COLI pool".

The memorandum provided an overview section which generally described a broad-based COLI pool as consisting of

a group of corporate-owned life insurance (COLI) policies covering a wide cross- section of a corporation's employees. Petitioner was the proposed beneficiary of the COLI policies to be written on the lives of petitioner's employees. WJ/Coventry's proposal focused on two issues raised by petitioner in a prior meeting. These two issues were described as "(i) achieving positive earnings in every year; and (ii) providing an exit if the tax laws change or Winn-Dixie's appetite for interest deductions declines."

The memorandum summarized the tax aspects of leveraged COLI with the following captioned diagram:



1 - Winn-Dixie makes deposits and pays loan interest to insurance carrier.

2 -Winn-Dixie receives withdrawals, loans and death proceeds from the insurance carrier.

3 - Winn-Dixie receives a tax deduction for loan interest paid.

The memorandum next explained the difference between the proposed broad-based COLI pool and petitioner's then existing leveraged COLI program being used to fund the MSP. The memorandum stated:

> Winn-Dixie is familiar with leveraged COLI and particularly with the tax arbitrage created when deductible policy loan interest is paid to finance non-taxable policy gains. Winn-Dixie's existing leveraged COLI policies provide this arbitrage and, having been purchased before passage of the 1986 Tax Reform Act, provide it beyond the $50,000 cap applicable to newer policies.
>
> A broad-based COLI Pool applies the same principle in ways that are effective under current law. But, where each of the existing policies was designed to fund a specific executive's benefit under the MSP, the Pool that we have illustrated would cover 38,000 employees at all levels of Winn-Dixie's workforce.

With respect to obtaining the employees' consent to purchase the COLI policies on their lives, the memorandum stated:

> We usually recommend that a company adopt or expand employee death benefits when installing a COLI Pool. This provides an immediate and meaningful benefit for employees, and it helps to provide a logic and incentive for obtaining employees' consent to being insured. The benefit may depend on the size of the pool and the amount of the insurance purchased on each employee. A death benefit in the range of $5,000 to $15,000 is typical for the Pools presented here. After an employee leaves the company, the benefit is normally reduced or discontinued. With normal rates of retirement and attrition, only a small proportion of the participants will receive a bene-

fit. As a result, the cost of providing the benefit is insignificant.

The memorandum also expressed an opinion on the tax issues raised by the proposed COLI pool, the legislative status of leveraged COLI, and exit strategies available to petitioner in the event that the tax laws change:

> What tax issues are raised by the COLI Pool?
>
> Deductibility of Interest. Because the COLI Pool involves systematic borrowing of increases in the policies' cash value, a deduction for interest to carry policy loans is allowed only if at least four of the first seven annual premiums are paid in cash. In addition, a deduction is allowed for interest on only the first $50,000 debt to carry policies on any one employee. The COLI Pool proposed here is designed to satisfy the 4-out-of-7 rule, and the financial illustrations take into account the $50,000 cap on loans for which interest deductions are allowed.
>
> * * * * * * * *
>
> What is the legislative status of leveraged COLI?
>
> In the past few years, Rep. Barbara Kennelly (D-Conn.) and Senator David Pryor (D-Ark.) have introduced bills that would impose new restrictions on the deductibility of interest paid on loans from COLI policies. No bill is now pending, but it is possible that one will be introduced in the future. Kennelly/Pryor, as the last such bill was generally known, was written with the participation and support of the National Association of Life Underwriters, and, if a similar bill does become law, we

do not believe the financial advantages of Winn-Dixie's COLI Pool would be seriously compromised.

History suggests that specific changes in the law that would address leveraged COLI would also allow grandfathering of existing policies. Past changes, for example, imposition of the $50,000 loan cap, have grandfathered existing policies, and the large number of major corporations that have created COLI pools is a significant political constituency. Of course, grandfathering cannot be assumed, and we have, therefore, kept the consequences of exit very much in mind in developing strategies for Winn-Dixie.

What exit strategies are available if the tax laws or Winn-Dixie's tax position changes?

A COLI Pool can become a financial burden if the tax arbitrage in the program loses its attractiveness. This can occur, for example, if Winn-Dixie's marginal tax rate on interest deductions becomes low and remains low, if Winn-Dixie becomes an alternative minimum taxpayer, or if the intended premium payment strategy becomes invalid through regulation. Likewise, Winn-Dixie's appetite for interest expense may be satisfied for reasons unrelated to deductibility.

* * * * * * * *

If it becomes necessary or useful to terminate the COLI Pool, or to discontinue further borrowing, Winn-Dixie will be able to do so without significant adverse effect. The policies can be put on a "paid-up" basis, either with

> the original carrier or with another carrier via a "1035" exchange, without incurring a tax liability, a negative effect on earnings, or a significant cash payment.

The memorandum outlined two proposed financial strategies for structuring the purchase by petitioner of the pool of COLI policies. The first strategy was labeled "cash management". The second strategy was labeled the "zero-cash strategy" and was described as follows:

> Under Strategy 2, Winn-Dixie would maximize its tax arbitrage by borrowing the first three premiums and would minimize its cash investment by withdrawing accumulated policy values to pay the next four premiums. The policies used in this zero cash strategy are specially designed to minimize cash outflows and to maximize the rate of return on investment. Thus, loads are minimal, the interest rate is high, and the loan spread is limited to 40 basis points. Because little cash is required, a higher premium can be used. We have illustrated an average premium of $3,000 per employee.

Petitioner elected strategy 2, the zero-cash strategy.

On January 25 and 27, 1993, Mr. Buerger sent revised copies[1] of the 1993 COLI proposal materials to Mr. McCook and Mr. Hlavacek. The revised 1993 COLI proposals outlined two scenarios for the amount of interest petitioner was to be charged for policy loans. Both interest scenarios were

---

[1] The above-quoted sections of the proposal remained substantially the same in each of the revised copies of the proposal.

based upon the zero-cash strategy.[2] The two scenarios for the zero-cash strategy were outlined as follows:

> Scenario 1 - Constant Loan Interest Scenario. In this scenario, it is assumed that Winn-Dixie's appetite for interest deductions remains large, and policy interest is charged at 11.06% throughout the life of the COLI Pool. This scenario results in the largest amount of earnings possible.
>
> Scenario 2 - Reducing Loan Interest Scenario. In this scenario, Winn-Dixie's appetite for interest deductions is assumed to reduce over time. To adjust to the change in circumstances, the interest rate under the COLI Pool policies is reduced to 8% after the fifteenth year. This scenario generates a somewhat smaller tax arbitrage, but the resulting earnings are nevertheless significant.

Included in the revised proposal memorandum dated January 27, 1993, were projections of petitioner's profit and loss, cash-flow, and balance sheet balances under scenario 1, the constant loan interest rate scenario, for the years 1993 through 2052. The projections were based on the assumption that premiums paid by petitioner would be financed by policy loans in all years except years 4 through 7. In the years 4 through 7, inclusive, premiums were to be paid using funds from policy withdrawals. The constant loan interest rate (scenario 1) projections included in the January 27, 1993, memorandum are attached as appendix A.

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[2] The Jan. 27, 1993, revised proposal assumed a pool covering 38,000 employees with an average premium of $3,000 per employee.

Under the constant loan interest rate scenario, the projections assumed that the interest rate paid by petitioner on policy loans remained constant at 11.06 percent[3] for the life of the pool. Amounts to be credited to petitioner on borrowed cash value were set at 40 basis points below the 11.06 percent being charged to petitioner.[4] Thus, the borrowed cash value would be credited at 10.66 percent. The remaining cash value was credited at 4 percent. The January 27, 1993, memorandum explains that "A COLI Pool generally works best when the interest rate on policy loans is highest."[5] The projections under the constant loan interest rate scenario were also based on the following assumptions:

Corporate tax bracket	38%
Population (number of insured employees)	38,000
Premium	$3,000 per life
Mortality assumption	100% of 1983 GAM[1]
Fee	$8 per participant annually

[1]The mortality assumption "GAM" was not defined in the proposal. Ultimately, petitioner and AIG agreed upon using the 1980 Commissioners Standard Ordinary Mortality Table B to estimate mortality.

Based upon the above assumptions, Coventry projected that the "pretax earnings effect" of the COLI plan for the first policy year (1993) would be a loss of $4,605,000,[6] before

---

[3] The 11.06-percent rate was based on Moody's Baa rate from November 1992, which was 8.96 percent. Coventry converted it to an arrears rate and added 1 percent to reach 11.06 percent.

[4] This is referred to as "loan spread". The Jan. 27, 1993, memorandum explains: "An effective COLI Pool should have a small 'spread' between the interest rate charged on policy loans and the amounts credited to borrowed cash values."

[5] The rate in effect for the MSP policies was 8.41 percent.

[6] See appendix A.

adjusting for the related reduction in income taxes. This pretax loss was based on the following projected figures for the end of the first policy year: Cash surrender value (CSV) of the COLI policies of $119,586,000 increased by death benefits of $2,016,000 and reduced by annual premiums of $114 million,[7] accrued loan interest of $11,902,000,[8] and administration fees of $304,000.[9] Similar projections for the years 1994 through 2052 produced pretax losses in each year.

With respect to the estimated 1993 premiums of $114 million, the projection indicated that petitioner would, in part, satisfy the premiums by borrowing $107,684,000 against cash surrender value. For 1994, the projection indicated that petitioner would partially satisfy its premium and interest payment[10] obligation by borrowing $113,929,000 and withdrawing $1,649,000 from the net cash value of the policy. For 1995, the projection indicated that a loan of $110,318,000 and a policy withdrawal of $14,731,000 would be used to pay a large portion of the premiums of $113,852,000 and interest payment of $24,486,000. Except for the next 4 years, 1996 through 1999, the projection indicated petitioner would finance a large portion of its premium and interest payments

---

[7] This amount is arrived at using the assumed premium per employee of $3,000 times the assumed 38,000 employees for a total of $114 million.

[8] This amount is the interest due from petitioner as calculated by Coventry on a projected first-year policy loan taken by petitioner in the amount of $107,684,000. Annual interest of 11.06 percent on $107,684,000 is actually $11,909,850.

[9] Using these figures the calculation is: $119,586,000 + $2,016,000 + ($114,000,000) + ($11,902,000)+ ($304,000) = ($4,604,000). The $1,000 variance between this calculation and the pretax loss of $4,605,000 in appendix A appears to be attributable to rounding of the components of the calculation.

[10] The projection indicated that petitioner would actually pay the estimated $11,902,000 of interest due on the 1993 loan of $107,684,000 in 1994. Interest accumulated on policy loans was payable in arrears.

with policy loans. For years 1996 through 1999, petitioner would generally finance its premium and interest payments through policy withdrawals. The policies' premiums were to be completely paid by 2007; therefore, no premium payments were projected for the years 2008 through 2052. However, for years 2008 through 2052, policy loans continued to be projected in amounts that were approximately between 90 percent and 95 percent of the amount of the annual loan interest payments.

The projection indicated that petitioner would sustain a negative "pretax earnings effect" on the COLI plan for every year the plan remained in effect. Thus, the projection for the years 1993 through 2052 indicated petitioner would incur net pretax out-of- pocket losses as follows:

Year	Pretax Loss Effect	Year	Pretax Loss Effect	Year	Pretax Loss Effect
1993	$4,605,000	2013	$16,390,000	2033	15,238,000
1994	8,403,000	2014	17,839,000	2034	14,769,000
1995	11,282,000	2015	18,071,000	2035	14,320,000
1996	10,399,000	2016	18,285,000	2036	13,828,000
1997	9,997,000	2017	18,492,000	2037	13,281,000
1998	9,559,000	2018	18,546,000	2038	12,674,000
1999	9,381,000	2019	18,446,000	2039	12,013,000
2000	9,756,000	2020	18,342,000	2040	11,312,000
2001	9,959,000	2021	18,228,000	2041	10,583,000
2002	10,310,000	2022	18,103,000	2042	7,675,000
2003	10,725,000	2023	17,968,000	2043	5,867,000
2004	11,358,000	2024	17,817,000	2044	8,374,000
2005	12,215,000	2025	17,645,000	2045	7,782,000
2006	13,151,000	2026	17,446,000	2046	7,214,000
2007	14,178,000	2027	17,215,000	2047	6,650,000
2008	10,134,000	2028	16,946,000	2048	6,110,000
2009	11,269,000	2029	16,643,000	2049	5,583,000
2010	12,420,000	2030	16,193,000	2050	5,070,000
2011	13,653,000	2031	15,086,000	2051	4,586,000
2012	14,973,000	2032	16,545,000	2052	4,742,000
	Total pretax loss				755,644,000

The projection of profit and loss also included an analysis of the effect of the COLI plan on petitioner's income tax li-

ability in each of the years 1993 through 2052. Assuming a 38-percent corporate tax bracket,[11] the projected $11,902,000 loan interest accrued and deducted by petitioner in the first policy year (1993) resulted in a projected tax saving of $4,524,000.[12] A projected deduction for estimated administration fees of $304,000 resulted in a projected tax saving in 1993 of $116,000.[13] Thus, the total projected tax benefits from deductions generated by the proposed COLI plan during the first policy year was $4,640,000.[14] The projection compared the estimated tax benefit of $4,640,000 to the estimated pretax loss effect of $4,605,000 resulting in a positive "after-tax earnings effect" of $35,000.[15] The after-tax earnings effect (the excess of tax savings over net pretax costs) was projected to increase substantially in subsequent years. Coventry's projected after-tax earnings effect was as follows:

Year	After-tax Earnings Effect	Year	After-tax Earnings Effect	Year	After-tax Earnings Effect
1993	$35,000	2013	$60,796,000	2033	$44,780,000
1994	1,021,000	2014	59,009,000	2034	43,361,000
1995	2,770,000	2015	58,409,000	2035	41,789,000
1996	3,642,000	2016	57,797,000	2036	40,124,000
1997	4,033,000	2017	57,161,000	2037	38,369,000
1998	4,458,000	2018	56,647,000	2038	36,529,000
1999	4,624,000	2019	56,250,000	2039	34,601,000
2000	9,997,000	2020	55,819,000	2040	32,582,000

[11] The corporate tax rate on all projections was an estimated combined Federal and State marginal tax rates.

[12] A deduction of $11,902,000 times an assumed tax rate of 38 percent actually results in a tax benefit of $4,522,760. But see *supra* note 8.

[13] For instance, a deduction of $304,000 times an assumed tax rate of 38 percent results in a tax benefit of $115,520.

[14] Thus, $4,524,000 + $116,000 = $4,640,000.

[15] For instance, a reduction in earnings due to amounts paid of $4,605,000 can be offset by a reduction in taxes of $4,640,000 for an overall after-tax earnings increase of $35,000.

2001	16,143,000	2021	55,353,000	2041	30,479,000
2002	22,799,000	2022	54,846,000	2042	30,466,000
2003	30,108,000	2023	54,291,000	2043	29,291,000
2004	37,980,000	2024	53,683,000	2044	23,772,000
2005	46,477,000	2025	53,017,000	2045	21,361,000
2006	55,822,000	2026	52,289,000	2046	18,971,000
2007	64,479,000	2027	51,492,000	2047	16,655,000
2008	68,339,000	2028	50,620,000	2048	14,423,000
2009	66,998,000	2029	49,664,000	2049	12,313,000
2010	65,616,000	2030	48,730,000	2050	10,347,000
2011	64,127,000	2031	48,327,000	2051	8,529,000
2012	62,524,000	2032	45,233,000	2052	6,264,000
Total after-tax earnings					2,246,431,000

The projected total after-tax earnings of more than $2.2 billion were the result of total projected income tax savings of more than $3 billion less projected pretax net losses. The projected tax savings were attributable to the anticipated tax deductions for policy loan interest and fees.[16] The effect on Winn-Dixie's after-tax earnings and cash-flow was projected to be positive in each year only because of tax benefits from interest and fee deductions. Absent such tax benefits, the effect on Winn-Dixie's earnings and cash-flow would be negative in every year.[17]

In February 1993, Mr. McCook decided to have petitioner engage in the proposed broad-based COLI plan. On March 25, 1993, Mr. Hlavacek sent Mr. McCook another projection under the constant loan interest rate scenario estimating the effect of the proposed COLI plan. The projection estimated, among other things, the effect over 60 years be-

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[16] Projected interest and fees over a 60-year period totaled $77,476,680,000 and $14,326,000, respectively.

[17] Similarly, the proposal memorandum projected the effect of the COLI purchase on petitioner's after-tax retained earnings balance on its balance sheet over 60 years. The proposal predicted that petitioner's retained earnings balance would increase by $2,241,491,000 over the 60 years.

ginning in 1993 of the proposed COLI purchase on petitioner's effective tax rate. The projection assumed an effective tax rate of 40 percent and predicted that the proposed COLI purchase would reduce petitioner's effective tax rate each year, reaching its lowest point of 26.54 percent in 2007.

AIG participated in the development of information for projections regarding petitioner's proposed COLI plan. A preliminary census reflecting the ages of the approximately 36,000 employees to be insured was prepared on May 28, 1993.[18] Mr. Buerger sent two more sets of revised projections to Mr. McCook. The first set of revised projections was sent on May 28, 1993, and the second was sent on June 4, 1993. Both projections were based on issuance of the proposed policies effective as of March 1993. The first set of revised projections assumed that petitioner's taxes were paid at a rate of 40 percent[19] for purposes of predicting the tax effect of the COLI purchase on petitioner's financial ratios. The second set of revised projections used a tax rate of 39 percent[20] and assumed just over 36,000 of petitioner's employees would be insured. This projection also assumed that maximum loans would be made in most years but that cash withdrawals would be made in policy years 4 through 7 and policy years 16 through 21. The June 4, 1993, projections are attached as appendix B.

Using the same basic analysis that had been used in the January projections, the June 4, 1993, projections again indicated that petitioner would sustain a pretax loss and a post-tax profit on the COLI policies for every year the plan remained in effect. See appendix B. Thus, for the years 1993

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[18] Before the preliminary census, the projections were based on estimates of the number of employees and their ages.

[19] See *supra* note 11.

[20] See *supra* note 11.

through 2052, the June 4, 1993, projections indicated the broad- based COLI plan would affect petitioner's profit and loss as follows:

Policy Year[1]	Pre-tax Earnings Effect	Tax Benefit From Interest Deduction	Tax Benefit From Admin Fee Deduction	After-tax Earnings Effect[3]
1993	[2]($4,188,000)	$4,368,000	$113,000	$292,000
1994	(7,885,000)	8,988.000	113,000	1,217,000
1995	(10,869,000)	13,887,000	113,000	3,130,000
1996	(9,972,000)	13,856,000	112,000	3,966,000
1997	(9,669,000)	13,823,000	112,000	4,266,000
1998	(9,366,000)	13,788,000	112,000	4,533,000
1999	(9,063,000)	13,750,000	111,000	4,799,000
2000	(9,243,000)	19,159,000	111,000	10,027,000
2001	(9,736,000)	25,088,000	111,000	15,462,000
2002	(10,013,000)	31,595,000	110,000	21,692,000
2003	(10,345,000)	38,733,000	110,000	28,498,000
2004	(10,879,000)	46,551,000	110,000	35,782,000
2005	(11,619,000)	55,104,000	109,000	43,595,000
2006	(12,428,000)	64,456,000	109,000	52,136,000
2007	(13,208,000)	73,436,000	108,000	60,336,000
2008	(9,182,000)	73,039,000	107,000	63,965,000
2009	(9,409,000)	72,612,000	107,000	63,310,000
2010	(9,651,000)	72,153,000	106,000	62,608,000
2011	(9,888,000)	71,661,000	105,000	61,878,000
2012	(10,104,000)	71,134,000	105,000	61,134,000
2013	(10,056,000)	70,569,000	104,000	60,616,000
2014	(11,085,000)	70,497,000	103,000	59,515,000
2015	(11,875,000)	69,905,000	102,000	58,132,000
2016	(12,704,000)	69,181,000	101,000	56,579,000
2017	(13,584,000)	68,405,000	100,000	54,921.000
2018	(14,384,000)	67,581,000	99,000	53,296,000
2019	(15,112,000)	66,710,000	98,000	51,696,000
2020	(15,905,000)	65,789,000	96,000	49,980,000
2021	(16,447,000)	64,818,000	95,000	48,467,000
2022	(16,336,000)	63,797,000	94,000	47,554,000
2023	(16,124,000)	62,724,000	92,000	46,692,000
2024	(15,898,000)	61,599,000	91,000	45,791,000
2025	(15,662,000)	60,421,000	89,000	44,848,000
2026	(15,417,000)	59,191,000	87,000	43,862,000
2027	(15,163,000)	57,908,000	85,000	42,831,000
2028	(14,901,000)	56,573,000	84,000	41,756,000

2029	(14,632,000)	55,187,000	82,000	40,637,000
2030	(14,352,000)	53,750,000	80,000	39,478,000
2031	(14,063,000)	52,264,000	78,000	38,279,000
2032	(13,765,000)	50,732,000	75,000	37,043,000
2033	(13,457,000)	49,155,000	73,000	35,771,000
2034	(13,141,000)	47,535,000	71,000	34,465,000
2035	(12,816,000)	45,873,000	69,000	33,126,000
2036	(12,483,000)	44,172,000	66,000	31,755,000
2037	(12,139,000)	42,435,000	64,000	30,360,000
2038	(11,784,000)	40,665,000	61,000	28,942,000
2039	(11,417,000)	38,865,000	59,000	27,507,000
2040	(11,035,000)	37,040,000	56,000	26,060,000
2041	(10,638,000)	35,194,000	53,000	24,609,000
2042	(10,223,000)	33,332,000	51,000	23,160,000
2043	(9,794,000)	31,460,000	48,000	21,714,000
2044	(9,344,000)	29,583,000	45,000	20,284,000
2045	(8,902,000)	27,707,000	43,000	18,847,000
2046	(8,455,000)	25,840,000	40,000	17,425,000
2047	(8,006,000)	23,990,000	37,000	16,022,000
2048	(7,563,000)	22,167,000	34,000	14,638,000
2049	(7,153,000)	20,378,000	32,000	13,256,000
2050	(6,739,000)	18,630,000	29,000	11,921,000
2051	(6,407,000)	16,932,000	27,000	10,552,000
2052	(6,244,000)	15,292,000	24,000	9,072,000
	(681,922,000)	2,691,027,000	5,011,000	2,014,115,000

[1] Policy years are from Mar. 1 to the end of February.

[2] Based on the underlying figures from which this amount was computed, the figure should be $4,189,000.

[3] In some instances the figures in this column vary from the sum of their components by $1,000. This appears to be due to rounding off, and any variances appear to be insignificant.

The June 4 projections indicate that without tax savings from policy loan interest and administration fee deductions, the earnings effect over 60 years would have been a negative $681,922,000. The tax savings over 60 years for interest and fee deductions were projected to be $2,696,038,000. After these tax benefits are taken into consideration, the projection indicated that petitioner would realize an after-tax profit of $2,014,115,000. These after-tax financial benefits were dependent on the tax savings flowing from the interest

and fee deductions being generated by the broad-based COLI plan.

Petitioner prepared a list of "Company Expense Reduction Opportunities" for fiscal year 1993 that listed 23 items of savings that totaled $329,093,000. The largest item of expense reduction on the list is "Proposed Corporate Life Insurance (COLI)". The list shows that this item (COLI) was estimated to be implemented on June 30, 1993, and that petitioner's estimated savings from COLI was $300 million. Mr. McCook testified that he thought this figure was derived from the "After-Tax Earnings Effect" shown in column J of appendix A.[21]

AIG is a major underwriter of COLI policies. AIG had been working with WJ/Coventry in preparing the COLI plan. Mr. Qureshi of AIG was the actuary who designed and priced the COLI policies purchased by petitioner. On June 4, 1993, Mr. Larry Walters of AIG, sent a Letter of Understanding regarding the COLI policies to Mr. McCook. The Letter of Understanding provided that petitioner would remit, as consideration for the policies, a net payment of $7,245,000, the difference between a total premium of $108,573,000 and an estimated first year policy loan of $101,328,000. In the Letter of Understanding, AIG agreed to provide life insurance coverage in accordance with the Policy Terms Overview. The Letter of Understanding required that the following conditions be met:

> 1. * * * [Petitioner] reviews and verifies the accuracy of the information contained on the Client Master Informa-

[21] Three hundred million dollars is the approximate total of the annual "After-Tax Earnings" projected for the policy years 1993 through 2007. The total projected After-Tax Earnings for the years 1993 through 2052 is $2,246,431,000. See appendix A.

tion Form, attached as Exhibit A.[22]
* * *

2. * * *[Petitioner] completes and certifies the information contained on the Certification of Employee Census form, attached as Exhibit B.[23]* * *

3. * * *[Petitioner] completes at least one Individual Life Insurance Application for each defined class of covered employees.

4. The aggregate number of employees within each defined class of covered employees, on the effective date of coverage, totals at least 2,000 lives.

5. The minimum annual premium for each covered employee is $3,000 and the maximum annual premium for each covered employee is $16,667.

6. AIG Life determines that each defined class of covered employees identified on the attached Client Master Infor-

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[22] Exhibit A, Client Master Information Form, listed petitioner's name as the name to appear on the policy and as the owner of the policy. Petitioner's main address was listed as the billing address, and Mr. McCook was named as the contact. The policy name was listed as "Excess Interest Life Ins.", and the effective date was listed as Mar. 1, 1993.

[23] Exhibit B, Certification of Employee Census, generally required that petitioner, as part of the application for coverage under the policies, certify that employee information on the census was correct. Among other things, petitioner certified that each individual on the census was a full-time (minimum 30 hours per week) employee, at least 18 years of age, no older than age 75, not absent from work for more than 10 consecutive business days within the 90 days preceding the date of certification, and that petitioner notify and obtain consent from each employee on the census that insurance is to be issued on his or her life.

mation Form and each employee identified on the Certification of Employee Census are acceptable for underwriting purposes and that the amounts of coverage applied for are acceptable.

In addition, the Letter of Understanding required that petitioner acknowledge and agree with the following:

1. This Letter of Understanding and attached Exhibits A and B contain the entire agreement between the parties and supersedes all previous agreements entered into between Client and AIG Life, or promises made with regard to the subject matter of this letter.

2. * * * [Petitioner] has reviewed with its own legal and tax advisors all present and future implications of its ownership of the Policies, including, but not limited to, the tax consequences of loans and/or withdrawals from the Policies and the deductibility thereof, and that it has not relied upon any representations of AIG Life or any employee, broker, or agent of AIG Life in that regard.

3. The premiums specified in the Policies are intended to meet the requirements of Section 7702 and Section 7702A of the Internal Revenue Code as in effect on the date of this letter so that the Policies will qualify as life insurance and will not be treated as modified endowment contracts. AIG Life does not

warrant or represent that the Policies will not be treated as modified endowment contracts.

4. The statements contained in the attached Exhibits A and B shall be considered as binding representations by the * * * [petitioner] and that such Exhibits shall be deemed attached to and made a part of the Policies.

The Letter of Understanding provided that if, within 90 days of June 4, 1993, all the above conditions had been met and AIG received the total first-year premium, then AIG would agree to issue to petitioner, in the State of Florida, the life insurance policies effective as of March 1, 1993.

By invoice dated June 9, 1993, Coventry requested payment of a balance due on the 1993 COLI policies of $7,245,000 from petitioner. The invoice reflected a total premium of $108,573,000, covering 36,191 total lives at $3,000 of premium each, less a policy loan of $101,328,000 to arrive at the net amount due.

On June 15, 1993, in accordance with the Letter of Understanding, AIG sent the "Policy Terms Overview" (PTO) to petitioner. The PTO provided for an effective date of March 1, 1993, and required that AIG and petitioner agree to several provisions under the insurance policies relating to the following: Claim Stabilization Reserve, Cost of Insurance Rates, Expense Caps, Surrender Fee, Interest Rate on Unborrowed Funds, and the Loan Interest Spread.

The PTO generally provided that AIG would establish on behalf of petitioner a claims stabilization reserve (CSR) for the policies. Petitioner could not withdraw or borrow against the amounts credited to the CSR. The maximum level of the CSR at the end of each year was generally determined to be the higher of the annualized "cost of insur-

ance"[24] (COI) charges actually collected in any one of 3 preceding policy years or the highest amount of death benefits actually incurred in any one of 3 policy years. COI charges were deducted from the premium that was paid and used to fund the CSR. The CSR was generally held available by AIG to pay death claims under the COLI policies.

On each policy anniversary, the PTO required AIG to compute an "Experience Cost", defined as COI charges collected from petitioner during the preceding year, less a 20 percent AIG retention fee, less the net amount for which AIG was at risk for claims during the preceding policy year. The negotiated 20 percent retention fee limited AIG's mortality-related profit. If the experience cost as of a policy anniversary was positive, it was added to the CSR's value as of the policy anniversary. If the experience cost was negative, it was subtracted from the CSR's value. AIG credited interest to the CSR at an annual rate of 4 percent. If, on a policy anniversary, the CSR balance exceeded its maximum permissible level, the excess was credited to the unrestricted policy account value. The PTO provided that the CSR would be held by AIG on behalf of petitioner for as long as the policies remained in force plus 1 year. At the end of the 1 year, a final accounting would be made by AIG and the balance of any remaining reserve would be refunded to petitioner.

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[24] "Cost of Insurance" was defined in the policy document. The COI was calculated on each monthly processing date. Generally, the COI was calculated under the following formula:

$$\text{COI} = \frac{(\text{Proceeds} - \text{Account Value})}{1{,}000} \times (\text{Value from Table of Maximum Insurance Rates})$$

Proceeds were defined as the benefits due to petitioner as the beneficiary. Account Value on the policy date was defined as the initial net premium less an annual expense charge.

Petitioner was to be charged 11.06 percent interest on amounts that it borrowed against the cash value of the policies. Pursuant to the PTO, the portion of the policy account value that was borrowed would earn interest at a rate not to exceed 40 basis points[25] or four-tenths of 1 percent below the amount charged on policy loans. Thus, the interest rate credited on the portion of the account value that had been borrowed was 10.66 percent.[26] The balance of the policy account values would earn interest at a rate guaranteed to be no less than 4 percent.

The policies provided for expense charges which would not exceed 23 percent of the premiums paid. The expense charges were comprised of premium expense charges of 17.8 percent and annual expense charges of 5.2 percent. The negotiated PTO reduced maximum expense charges from 23 percent to 8.934 percent of premiums paid.

Mr. McCook approved the purchase of the 1993 COLI policies, and on June 17, 1993, Mr. McCook, on behalf of petitioner, executed the June 4, 1993, Letter of Understanding. On the same day, petitioner remitted the net amount of $7,245,000 to AIG as payment for the policies.

The 1993 COLI policy forms were registered and approved in form and for sale by the insurance commissioner of the State of Florida. Initially, the total number of lives included, subject to eligibility, under the 1993 COLI policies was 36,191 as of June 17, 1993.

On June 17, 1993, petitioner paid WJ/Coventry $300,000 pursuant to an invoice dated June 11, 1993. The payment

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[25] Each basis point equals one one-hundredth of a percent (0.01 percent). Thus, 40 basis points is equivalent to 0.40 percent.

[26] The 10.66 percent figure is arrived at by reducing the loan interest rate of 11.06 percent by 0.40 percent.

was for services to be performed in year 1 of an administration agreement for the 1993 COLI policies. Also on June 17, 1993, Mr. McCook signed a Notification Certificate as a condition precedent to the sale of the COLI policies in which petitioner certified that it would notify the employees of the purchase of the COLI policies and give them an opportunity to refuse the coverage.

On July 19, 1993, Mr. McCook executed the PTO.[27] Also on July 19, 1993, Mr. McCook accepted receipt of the COLI policy contract documents from AIG and authorized Coventry to retain possession of the policies on petitioner's behalf.[28] The type of coverage provided was listed as "excess interest life". The person whose life was insured under each policy was one of petitioner's employees. Petitioner was listed as the owner and beneficiary of each policy.

The rights and liabilities of AIG and petitioner were governed by insurance policy forms (Policy Form), riders to the policies, the Letter of Understanding, and the PTO. The Letter of Understanding and the PTO set forth essential elements of the agreement between petitioner and AIG and amended and tailored the COLI policies to petitioner.

Policy face amounts varied with the age of each insured. Generally, petitioner's death benefits were governed by policy Option A, which provided for benefits based on the larger of the face amount plus the account value on the date of death, or the account value on the date of death multiplied by a specified percentage based on the age of the insured.[29] The

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[27] Mr. Walters of AIG signed the PTO on July 15, 1993.

[28] The contracts were listed on the delivery receipt as being policy Nos. 5003000001 through 5003035983.

[29] Some of the death benefits were paid under Option B, which was calculated to include the account value in the face amount, and the insurance proceeds were determined to be the larger of the face amount on the date

applicable mortality table was the 1980 Commissioners Standard Ordinary Mortality Table B, Age Last Birthday, referred to as the CSO-B table. Under the terms of the policies, death benefits from a policy would first be used to reduce any outstanding loan.

Under the terms of the policies, petitioner could withdraw part of the cash value of each COLI policy. However, a withdrawal could not exceed the "net cash value"[30] of the policy.

The policies also permitted petitioner to borrow an amount that, with interest to the next policy anniversary, would not exceed the net cash value of the policy. The policies provided that at the insured's death, any policy debt will be deducted from the proceeds of that policy. The policies were the sole security for any loans. Interest on petitioner's loans was due on each policy anniversary date. The policies provided for both a fixed and variable loan interest rate.

The policies were modified by a Renewable Level Term Insurance Rider. The rider provided death benefits equal to the amount of death benefits lost as a result of a withdrawal from the account value. Under the provisions of the rider, petitioner had the option on any policy anniversary date to elect to change from the 11.06-percent policy loan interest rate to a fixed rate of 10 percent in arrears or 9.1 percent in advance which would apply to both old and new policy loans.

(Continued. . .)

of death, or the account value on the date of death multiplied by a specified percentage.

[30] The net cash value of the policy was defined as the cash value less any prior withdrawals and any policy debt. The cash value was defined as the greater of the Guaranteed Cash Value, or the Account Value less the surrender charge that applies. The Guaranteed Cash Value was determined by a Table of Guaranteed Values provided with the policy.

For the 1993 COLI policy year March 1, 1993 to 1994, petitioner elected the variable loan interest rate of 11.06 percent.

The final provisions governing the COLI policies purchased by petitioner in June 1993 were devised to produce results in accord with those set forth in the June 4, 1993, projections contained in appendix B.

On July 19, 1993, petitioner entered into an Administrative Services Agreement with Coventry in which petitioner appointed Coventry as the administrator of the COLI pool. Under the agreement, petitioner was to pay $300,000[31] in each of the first 2 years and $200,000 annually in all subsequent policy years, and Coventry was to perform the following services in connection with the COLI policies:

(a) On the basis of census information supplied by petitioner

  (1) Identify which of the petitioner's employees may become insured;

  (2) Calculate the face amounts of the policies and the first year premiums for the covered employees;

  (3) Determine and process new insureds and process any change in the status of any insured;

  (4) Make the necessary calculations with respect to premiums, loans, withdrawals, loan interest, death claims and/or any other periodic payments;

(b) Provide consolidated invoice and itemization to petitioner and AIG;

(c) Receive and inspect the insurance policies from AIG and forward them to petitioner;

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[31] Petitioner deducted $100,000 of the $300,000 on its income tax return for the fiscal period ending June 30, 1993.

(d) Search government databases and other sources for covered deceased employees and obtain death certificates for deceased insureds;

(e) Provide petitioner with ongoing advice with respect to financial options and strategies related to 1993 COLI polices; and

(f) Provide petitioner with various reports including insurance value reports, year-end summaries, accounting reports and custom-designed decision-support reports.

For employees who died while in petitioner's employ, petitioner filed an Employer's Statement through its plan administrator, Coventry, who would then present the claim to AIG. Coventry, as plan administrator, was responsible for ascertaining employee deaths for those employees that died while no longer in petitioner's employ.

Westport Management, an organization that performs administrative services for life insurance companies, was engaged by AIG and WJ/Coventry to administer petitioner's COLI policies. In order to ascertain deaths of former employees, Coventry would ask Westport to perform "Social Security sweeps", by checking data base files to determine whether any covered former employee had died. After the purchase of the policies and input of the COLI policy data on its computer system, Westport began its administrative duties, regularly preparing performance and accounting reports, which were provided to Coventry and AIG. On every policy anniversary, Westport calculated all values on a monthly basis for all policies for the coming year. On petitioner's behalf, Coventry administered the COLI plan, acted as an intermediary with AIG, and checked reports and other information provided by AIG and Westport to ensure correctness. Every month and on request, Coventry received

reports from Westport on past and expected performance of the policies and policy loans. From these reports, Coventry generated annual and periodic policy value and other reports and journal entries showing aggregate policy activity. The Coventry reports included information about the CSR, experience rating, cash value calculations, claims, refunds and recisions. The Coventry reports also included information about the amount of tax savings the COLI program was generating for petitioner.

From 1993 through 1996, petitioner kept the employee COLI policies in force. AIG billed petitioner for premiums and interest annually on a net basis, as set forth below:

June 1993, Policy year beginning March 1, 1993:

Premium	$108,573,000
Loan	(101,328,000)
Net premium	[1]7,245,000

[1]A revised invoice was sent on Sept. 21, 1993, which reflected a reduction in insureds from 36,191 to 35,983 due to a recision of 208 policies. Thus, the calculation was as follows:

Premium	$107,949,000.00
Loan	(100,770,140.06)
Net premium	7,178,859.94
Less amount paid	(7,245,000.00)
Balance owed petitioner	66,140.06

Policy year beginning March 1, 1994:

Premium	$107,862,000.00
Loan	(108,877,159.95)
Interest	11,136,375.63
Balance due	10,121,215.68

Policy year beginning March 1, 1995:

Premium	$107,685,000.00
Loan	(112,165,202.89)
Withdrawal	(4,080,660.74)
Net premium due	(8,560,863.63)
Interest	23,140,858.57
Balance due	[1]14,579,994.94

[1]Policy year beginning Mar. 1, 1995, was revised at least twice. The final revision resulted in the following:

Premium	$107,685,000.00
Loan	(112,112,913.04)
Withdrawal	(4,134,020.12)
Net premium due	(8,561,933.16)
Interest	23,140,858.57
Balance	14,578,925.41
Amount paid	14,579,994.94
Net refund due	1,069.53

Policy year beginning March 1, 1996:

Premium	$107,553,000.00
Withdrawal	(129,934,414.41)
Net premium due	(22,381,414.41)
Interest	35,497,690.97
Balance due	13,116,276.56

COI and policy expense charges (DAC tax, State premium tax, commission and loading charges) under petitioner's COLI policies were as follows:

Policy Year	Cost of Insurance	Expense Charges	Total
1993	$3,354,561	$3,412,447	$6,767,008
1994	4,641,249	4,721,130	9,362,379
1995	4,890,649	8,516,817	13,407,466
1996	5,173,414	8,990,642	14,164,056

The annual amounts of cash paid by petitioner to AIG for the COLI policies, compared with the total of COI and policy expense charges for corresponding years, were as follows:

Policy Year	Cash Paid by Petitioner	COI Plus Expense Charges
1993	$7,178,860	$6,767,008
1994	10,121,216	9,362,379
1995	14,578,925	13,407,466
1996	13,116,277	14,164,056
Total	44,995,278	43,700,909

For the first 4 COLI policy years, beginning March 1, 1993, AIG billed petitioner $431,049,000 in gross premiums and $69,774,925 in interest charges. Gross premiums and interest charges totaled $500,823,925. Of this total amount, petitioner remitted the above-calculated $44,995,278[32] in cash.

Following the enactment of tax law changes in 1996, petitioner commenced discussions with AIG, Coventry, and WJ concerning the phaseout or discontinuance (unwind) of the COLI policies. These discussions concerned the approximately 36,000 policies purchased by petitioner in 1993 plus approximately 11,000 and 9,000 COLI policies purchased in 1994 and 1995, respectively. On October 22, 1996, Mr. McCook sent a letter to Mr. Qureshi, vice president of AIG, which stated:

> Winn-Dixie has used AIG policies on three corporate owned life insurance (COLI) programs over the last several years. Because of the recent tax law changes, we have been working with Alan Buerger of the Coventry Group and Bruce Hlavacek of Wiedemann and Johnson, to try to minimize the financial impact on Winn-Dixie for the phase out of COLI.

[32] See preceding table for cash total.

Mr. Qureshi responded to Mr. McCook's October 22, 1996, letter and acknowledged the recent change in the law with respect to the COLI policies. Mr. Qureshi also indicated that AIG would be pleased to discuss various options available to petitioner.

Coventry prepared a draft booklet dated October 30, 1996, which contained, among other things, an overview of the current status of petitioner's COLI pool, an opinion of the financial effect of the 1996 tax law change, and explanations of several exit and unwind strategies. The draft booklet indicated that petitioner had three separate enrollments covering approximately 55,740 lives. The first enrollment "WD1" was in relation to the policies written in 1993 covering 35,810 employees. The second enrollment "WD2" was in relation to the policies written on November 30, 1994, covering 10,704 employees. The third enrollment "WD3" was written on June 30, 1995, and covered 9,226 employees. With respect to the effect of the 1996 tax law changes on petitioner's COLI policies, the booklet stated in pertinent part:

> In August of 1996, Congress amended the Internal Revenue Code was [sic] to deny deductions for any interest on policy loans on the lives of employees, officers, and persons financially interested in a trade or business maintained by the taxpayer. The disallowance was retroactive to January 1, 1996, except that deductions may be continued through 1998 on up to 20,000 policies. The deduction on those policies, however, must be based on an interest rate no higher than Moody's average corporate bond rate, and only 90% of such interest is deductible in 1997 and 80% thereof is deductible in 1998.
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> * * * * * * * *

In the aggregate, the three enrollments cover 55,740 lives with aggregate outstanding loans of about $500 million at interest rates averaging 11%. At a 39% tax bracket, these policies would produce tax deductions worth $21,450,000 per year.

Under the amended law, assuming aggregate indebtedness of $195 million on the "best" 20,000 policies and a Moody's rate of 8% per annum, the following savings will be available:

Calendar 1996	$6,084,000
Calendar 1997	5,475,600
Calendar 1998	4,867,200

The booklet next identified three basic exit strategies for petitioner. The three strategies were listed as the policy surrender, policy unwind, and aggressive tax strategy. The policy surrender strategy generally entailed the cancellation or surrender of the policy and the receipt by petitioner of the net cash value of the policy. The booklet recommended under this strategy that petitioner maintain the policies on 20,000 lives in fiscal years 1996 and 1997.

With respect to the policy unwind strategy, in lieu of surrendering the policies, petitioner was informed that it could keep the policies in force and allow the unrealized gains related to the policies to be paid out eventually as tax-free death benefits. The booklet further stated that in order to unwind a policy, petitioner "would withdraw a portion of the cash value equal to premiums paid (i.e., Winn-Dixie's tax basis) and apply the withdrawal to repay an equal amount of loan." The booklet indicated that the result of such a withdrawal and repayment is a policy with a greatly reduced cash value, substantially all of it borrowed.

The third strategy, the aggressive tax strategy, suggested that under the revised statute, deductions were disal-

lowed only with respect to policies on the life of an individual who was an officer or employee or was financially interested in petitioner's trade or business. The booklet further indicated that counsel for Coventry believed that a strong argument could be made that the disallowance described by the statute did not apply where the insured was a former officer or employee or was not financially interested. Based on this argument, the booklet gave an example which assumed an additional $200 million of aggregate indebtedness could be attributed to petitioner's former employees upon whom policies were still maintained. As a result of the additional $200 million of aggregate indebtedness, the booklet concluded that the tax savings in each year would be equal to 39 percent of 11 percent of $200 million or $8,580,000, for as long as the loans remained in force.

In a letter to Mr. Qureshi dated September 8, 1997, Mr. McCook indicated that in light of the passage of the legislation pertaining to leveraged COLI, petitioner was working toward a more complete understanding of the COLI policies it purchased from AIG. Finally, in letters dated December 4, 1997, Mr. McCook notified Mr. Qureshi and Mr. Buerger of petitioner's intent to cancel all three blocks of leveraged COLI policies. Mr. McCook indicated in his notice to Mr. Qureshi that petitioner wished to surrender COLI blocks I, II, and III as of November 1, October 30, and June 30, 1997, respectively.

OPINION

On its return for the fiscal year ending June 30, 1993, petitioner claimed a deduction of $3,735,544 for accrued interest on loans from COLI policies that petitioner purchased in

1993.[33] Petitioner also claimed a $100,000 deduction for administrative fees related to these COLI policies.[34] Respondent disallowed the deductions after determining that the 1993 COLI Plan was tax motivated, unsupported by any independent business purpose, and lacked economic substance. Respondent argues that the arrangement was a sham.

The starting point for determining whether the form of a particular transaction will be recognized for tax purposes is the Supreme Court's decision in *Gregory v. Helvering*, 293 U.S. 465, 469, (1935), wherein the Court stated:

> The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted* * * But the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended.

In *Gregory*, the Court denied reorganization treatment with respect to a stock distribution even though the taxpayers had followed each step required by the Code for a reorganization. In deciding that the distribution was taxable as a dividend, the Court held that the structure of the transaction was a "mere device" for the "consummation of a precon-

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[33] This was approximately one-third of the total policy loan interest that would accrue during the first policy year that began Mar. 1, 1993, and ended Feb. 28, 1994. The $3,735,544 was interest attributable to the period Mar. 1 through June 30, 1993. We note that petitioner deducted interest on these "loans" for the period Mar. 1 through June 30, 1993, even though the COLI policies and policy loans were not finalized until mid-June 1993. Respondent argues that interest cannot accrue for a period prior to the time the loan was actually made. Because of our disposition, we need not address this issue.

[34] This was one-third of the $300,000 administrative fee for the first policy year that began Mar. 1, 1993, and ended Feb. 28, 1994.

ceived plan" and not a reorganization within the intent of the Code as it then existed. *Id.* Because the transaction lacked economic substance, as opposed to formal reality, it was not "the thing which the statute intended." *Id.*; see *Kirchman v. Commissioner*, 862 F.2d 1486, 1490-1491 (11th Cir. 1989), affg. *Glass v. Commissioner*, 87 T.C. 1087 (1986).

A transaction that lacks substance is not recognized for Federal tax purposes. See *ACM Partnership v. Commissioner*, 157 F.3d 231, 247 (3d Cir. 1998), affg. in part and revg. in part T.C. Memo. 1997-115; *United States v. Wexler*, 31 F.3d 117, 122 (3d Cir. 1994). Denial of recognition means that such a transaction cannot be the basis for a deductible expense. See *United States v. Wexler*, *supra* at 122. Citing the Supreme Court's decision in *Gregory*, the Court of Appeals for the Eleventh Circuit in *Kirchman v. Commissioner*, *supra*, stated the doctrine as follows:

> The sham transaction doctrine requires courts and the Commissioner to look beyond the form of a transaction and to determine whether its substance is of such a nature that expenses or losses incurred in connection with it are deductible under an applicable section of the Internal Revenue Code. If a transaction's form complies with the Code's requirements for deductibility, but the transaction lacks the factual or economic substance that form represents, then expenses or losses incurred in connection with the transaction are not deductible. [*Id.* at 1490.]

Because the transactional events at issue in this case actually occurred, we limit our inquiry to the question of whether the

substance of the COLI transaction corresponds with its form.[35]

Section 163(a) provides that "There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness." Court opinions have clearly established that a lack of economic substance may operate to bar interest deductions arising under section 163. See *Knetsch v. United States*, 364 U.S. 361, (1960);[36] *United States v. Wexler*, *supra*; *Goldstein v. Commissioner*, 364 F.2d 734 (2d Cir. 1966), affg. 44 T.C. 284 (1965). Interest payments are not deductible if they arise from transactions "that can not with reason be said to have purpose, substance, or utility apart from their anticipated tax consequences." *Goldstein v. Commissioner*, *supra* at 740; see also *Sheldon v. Commissioner*, 94 T.C. 738 (1990). "Such transactions are said to lack 'economic substance.'" *Lee v. Commissioner*, 155 F.3d 584, 586 (2d Cir. 1998) (quoting *Jacobson v. Commissioner*, 915 F.2d 832, 837 (2d Cir. 1990), affg. in part and revg. in part T.C. Memo 1988-341), affg. in part and remanding in part on another ground T.C. Memo 1997-172.

The fact that an enforceable debt exists between the borrower and lender is not dispositive of whether interest aris-

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[35] In *Kirchman v. Commissioner*, 862 F.2d 1486, 1492 (11th Cir. 1989), affg. *Glass v. Commissioner*, 87 T.C. 1087 (1986), the court observed:

> Courts have recognized two basic types of sham transactions. Shams in fact are transactions that never occur. In such shams, taxpayers claim deductions for transactions that have been created on paper but which never took place. Shams in substance are transactions that actually occurred but which lack the substance their form represents.* * *

[36] In *Knetsch v. United States*, 364 U.S. 361 (1960), the Court applied sec. 163(a) of the 1954 Code. The language of sec. 163(a) of the 1954 Code remained unchanged in the 1986 Code. See sec. 163(a); see also *United States v. Wexler*, 31 F.3d 117, 123 (3d Cir. 1994).

ing from that debt is deductible under section 163. Rather, the overall transaction, of which the debt is a part, must have economic substance before interest can be deducted. See *Lee v. Commissioner*, *supra* at 587; *United States v. Wexler*, *supra* at 125. If this were not the rule, every tax shelter, no matter how transparently sham, could qualify for an interest expense deduction as long as there was a real creditor in the transaction that demanded repayment. Such a result would be "contrary to the longstanding jurisprudence of sham shelters from *Knetsch* on down." *Lee v. Commissioner*, *supra* 155 F.3d at 587.

In determining whether a transaction or series of related transactions constitute a substantive sham, both this Court and a majority of the Courts of Appeals have utilized a flexible analysis that focuses on two related factors, economic substance apart from tax consequences, and business purpose. See *ACM Partnership v. Commissioner*, *supra*; *Karr v. Commissioner*, 924 F.2d 1018, 1023 (11th Cir. 1991); accord *Casebeer v. Commissioner*, 909 F.2d 1360 (9th Cir. 1990), affg. in part and revg. in part on another ground *Larsen v. Commissioner*, 89 T.C. 1229 (1987); *James v. Commissioner*, 899 F.2d 905, 908-909 (10th Cir. 1990), affg. 87 T.C. 905 (1986); *Shriver v. Commissioner*, 899 F.2d 724, 727 (8th Cir. 1990), affg. T.C. Memo. 1987-627; *Rose v. Commissioner*, 868 F.2d 851, 854 (6th Cir. 1989), affg. 88 T.C. 386 (1987); *Kirchman v. Commissioner*, *supra*; *United Parcel Serv. of Am., Inc. v. Commissioner*, T.C. Memo. 1999-268.[37]

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[37] In certain situations courts have held that a transaction that lacks economic substance, other than the production of a tax benefit, is a substantive sham regardless of the motive of the taxpayer. See *Knetsch v. United States*, *supra* at 365; *Dewees v. Commissioner*, 870 F.2d 21, 35 (1st Cir. 1989); *Kirchman v. Commissioner*, *supra* at 1492.

Economic substance, in this context, is determined by objective evaluation of changes in economic position of the taxpayer (economic effects) aside from tax benefits. See *Kirchman v. Commissioner*, *supra* at 1492; accord *Knetsch v. United States*, *supra* at 366 ("nothing of substance to be realized * * * from this transaction beyond a tax deduction"); *ACM Partnership v. Commissioner*, *supra* at 248; *Sheldon v. Commissioner*, *supra*. The inquiry into whether there was a legitimate business purpose involves a subjective analysis of the taxpayer's intent. See *ACM Partnership v. Commissioner*, *supra* at 247; *Kirchman v. Commissioner*, *supra* at 1492.

We will begin with an examination of the economic substance of petitioner's 1993 COLI plan. In doing so, we focus on the COLI transaction in its entirety rather than any single step. See *Kirchman v. Commissioner*, *supra* 862 F.2d at 1493-1494.

Petitioner's 1993 purchase of COLI on the lives of approximately 36,000 of its employees was done pursuant to an overall plan that projected costs and benefits for each year over a 60-year period. See appendixes A and B. Petitioner also recognized that circumstances might well change during that period that would cause it to modify or terminate the plan. In fact, the COLI plan was impacted by legislation in 1996, and the COLI policies were terminated in 1997. However, for the first 2 years, the COLI plan was followed and it produced results that were consistent with plan projections.[38] We will, therefore, examine the economic substance

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[38] The instant case involves deductions for accrued interest and fees in the first plan year. The first year of the COLI insurance began on Mar. 1, 1993, and ended on Feb. 28, 1994. The deductions in issue were based on an allocation of the interest and fees that had accrued during petitioner's taxable year ended June 30, 1993.

of the COLI transactions by analyzing the projections that reflect the plan.

Shortly after having been approached by WJ/Coventry regarding proposals for COLI to be purchased from AIG, petitioner decided that it was interested in what was described as a "zero-cash strategy". This strategy was based on an elaborate plan involving the purchase of life insurance on the lives of over 36,000 of petitioner's then current employees. The plan was complex and depended upon relationships between many factors, including number of lives insured, premium levels, policy expenses, rates of interest to be charged and credited, policy loans, cash surrender values, withdrawals from cash surrender values, and death benefits. Petitioner was to be the owner and beneficiary of the policies. Detailed projections were prepared to demonstrate the financial impact of the plan. The projections assumed a high rate of interest (11.06 percent) would be charged to petitioner on its policy loans. This would be countered by a high rate of interest to be credited to petitioner on the portion of the gross cash surrender value that petitioner had borrowed against. The crediting rate was 40 basis points below the rate charged to petitioner on its policy loans (10.66 percent). The rate to be credited on the unborrowed portion of the gross cash surrender value was 4 percent. Policy loans by petitioner would be used to pay most of the premiums and interest with the result that petitioner's net equity in the policies would remain relatively small. Death benefits would be applied to reduce outstanding policy loans.

The profit and loss statements in the projections illustrate the pretax effect and the after-tax effect that the COLI plan would have on petitioner. The difference between pretax and after-tax effects was based on the income tax savings that would result from deducting policy loan interest and administrative fees. Policy loan interest was clearly the

dominant element. All the various projections prepared before the actual purchase of the policies in June 1993 show that the pretax effect on petitioner for each policy year was a loss and that the after-tax effect was a significant profit.

The projections submitted to petitioner on June 4, 1993, were prepared just before petitioner's purchase of the COLI policies in June 1993. These projections are attached as appendix B. We shall use figures from the projections in appendix B to illustrate the COLI plan's lack of economic substance.

The elements of the COLI plan and their projected impact on petitioner at the completion of the first policy year were as follows. Petitioner would make a premium payment of $108,573,000 and simultaneously borrow $101,328,000 against the policy. This required petitioner to pay the balance of $7,245,000 to AIG to satisfy the premium. At the end of the policy year, interest accrued on petitioner's policy loans would be $11,191,000, and petitioner would also have incurred administrative fees of $290,000. What benefit was petitioner to get for these costs? At the end of the first policy year, the COLI policies would have net cash surrender value of $11,287,000. In addition, based on actuarial determinations, petitioner expected death benefits from the COLI policies in the first year to be $3,250,000.[39] Based on the combination of these first-year costs and benefits, the net effect of the COLI plan was a first-year loss[40] of $4,188,000 computed as follows:

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[39] Under the terms of the policies, death benefits from a policy would first be used to reduce any outstanding loan.

[40] The projections refer to the loss as negative pretax earnings.

Net premium payment		$7,245,000
Interest on policy loan		11,191,000
Administrative fees		290,000
		18,726,000
Less:	Net cash surrender value	11,287,000
	Death benefits	3,250,000
		14,537,000
Loss		[1]4,189,000

[1]The June 1993 projection shows $4,188,000. This is apparently due to rounding or a math error.

Following the same approach, the June 1993 projections show the COLI plan producing pretax losses in the next 2 policy years of $7,885,000 and $10,869,000, respectively. Thereafter, the pretax losses over the next 57 years range from $6,244,000 in the last year to $16,447,000 in year 2021. The total of pretax losses for the projected 60 years was $681,922,000. In each and every year, the combined yearly pretax benefits from the policies; i.e., the expected death benefits from the 36,000 policies plus the year-end net equity value of the policies, were substantially less than petitioner's cost of maintaining the policies.

The next part of the June 1993 profit and loss projections illustrates the "tax effect" of the COLI plan. The profit and loss statement contained in the June 1993 projections shows first-year income tax savings from the COLI plan of $4,480,000. This amount is composed of tax savings of $4,368,000 attributable to a deduction of accrued first-year interest on policy loans of $11,191,000 and tax savings of $113,000 attributable to a deduction of first-year administrative fees of $290,000. Based on this, the projected "after- tax

earnings effect" for the first policy year was $292,000.[41] Similar projections for each of the following 59 years show that while the "pretax earnings effect" of the plan resulted in losses, the "after-tax earnings effect" continued to be positive in each year reaching its peak in the year 2008 when the "after-tax earnings effect" would be $63,965,000. This amount was arrived at by subtracting the pretax loss of $9,182,000 from projected income tax savings of $73,146,000.[42] The projected income tax savings of $73,146,000 were attributable to tax deductions for interest of $187,279,000 and administrative fees of $276,000. The June 1993 projections indicate that had the 1993 COLI plan remained in effect through the year 2052, petitioner's total pretax loss over 60 years would have been $681,922,000 but that the total tax saved because of policy loan interest and fee deductions would have exceeded $3 billion, resulting in a total "after-tax earnings effect" of more than $2 billion.

The June 1993 projections contain a cash-flow analysis for each policy year from 1993 to 2052. The structure of the zero-cash strategy was intended to produce a positive after-tax cash-flow for each policy year. Thus for the first year, the plan was to produce a positive cash-flow of $196,000 after factoring in tax savings from deducting policy loan interest and fees.[43] Without the savings from these deductions, there

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[41] The above figures were taken from the June 1993 projections reflected in appendix B. The totals vary by $1,000, apparently due to rounding off the last three digits.

[42] See *supra* note 41.

[43] In addition, the plan would result in petitioner's having a cumulative net equity in the COLI policies at the end of the first policy year of $96,000. Cumulative net equity was the gross surrender value of the policies minus outstanding policy loans and accrued policy loan interest. Gross cash surrender value of $112,471,000 minus the sum of the outstanding loan of $101,184,000 and accrued loan interest of $11,191,000 equals $96,000. See appendix B, Balance Sheet Summary. The combination of

would have been a negative cash-flow of over $4 million. The projections show increasing positive after-tax cash-flows for each of the following 59 years. Projected after-tax cumulative cash-flow for the entire 60-year period was more than $2 billion. Cumulative net equity at the end of each year varied, rising in some years and falling in others but, because of the policy loans and withdrawals, remained relatively small in relationship to the numbers in the overall plan. For example, cumulative net equity after 15 years was projected to be $498,000, whereas cumulative positive cash-flow was projected to be $289,263,000. See appendix B, Cash Flow. Without the tax savings from tax deductions for policy loan interest and fees, there would have been a substantial negative cash-flow in each year, and the costs of maintaining the COLI plan would have greatly exceeded benefits.

We recognize that one of the normal benefits of life insurance is the death benefit to be received if the insured dies before the insured's actuarially determined life expectancy. Thus, the predictable cost of maintaining life insurance might be greater than predictable death benefits and still be justified by the financial protection that insurance provides against the financial consequences of the unexpected death of the insured. But as we discuss later, petitioner had no such reason or purpose for engaging in the 1993 COLI program. Petitioner suggests that the policies could conceivably produce tax-independent benefits if some catastrophe were to occur that would produce large, unexpected death benefits. We are convinced that this was so improbable as to be unrealistic and therefore had no economic significance. In-

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(Continued...)

cumulative net equity and positive cash-flow equals the projected positive after-tax earnings effect of $292,000. $96,000 plus $196,000 equals $292,000.

deed, petitioner makes no pretense that it purchased these policies in anticipation of, or to protect itself against, a catastrophic event. The policies were on the lives of 36,000 individual employees of various ages who lived in diverse locations. The insured employees' lives were to remain insured even after their employment was terminated. The anticipated mortality of this large group was actuarially determined, and both AIG and petitioner engaged in the COLI transactions based on these actuarial expectations. While there would obviously be some variation in the actual mortality of the insured population, such variations were not expected to significantly affect the plan. And as explained later, the function of the claims stabilization reserve was to ameliorate fluctuations in actual mortality experience.

Economic substance depends on whether, from an objective standpoint, the transaction was likely to produce economic benefits aside from tax deductions. See *Kirchman v. Commissioner*, 862 F.2d at 1492; *Bail Bonds by Marvin Nelson, Inc. v. Commissioner*, 820 F.2d 1543, 1549 (9th Cir. 1987), affg. T.C. Memo. 1986-23. Viewing the COLI plan as a whole, we find that the only function of the plan was to produce tax deductions in order to reduce petitioner's income tax liabilities. Without the tax deductions, the plan as designed would produce a negative cash-flow and a negative earnings effect for petitioner in each and every year the plan was in effect. Consequently, the COLI transactions lacked economic substance apart from producing tax deductions.

In determining whether a transaction should be respected for tax purposes, we also look to whether the taxpayer had a business purpose for engaging in the transaction other than tax avoidance. See *Frank Lyon Co. v. United States*, 435 U.S. 561, 583-584, (1978); *Kirchman v. Commissioner*, *supra* at 1492; *Bail Bonds by Marvin Nelson, Inc. v. Commissioner*, *supra* at 1549. Petitioner argues that it had

an economic objective and valid business purposes for entering into the COLI transaction other than tax avoidance. Petitioner alleges that before entering into the 1993 COLI transaction, it had become concerned with increasing costs associated with its Winn-Flex program and that it decided to implement the COLI program as a mechanism for obtaining funds to pay such costs.

Before entering into the COLI transaction, there were numerous versions of profit and loss and cash-flow projections, which were consistently formatted so that petitioner could compare the pretax earnings effect to the post-tax earnings effect. Petitioner requested multiple versions of the projections at various estimated combined Federal and State marginal tax rates in order to see what effect a change in rates would have on the proposed COLI transaction. On the other hand, petitioner produced no contemporaneously prepared documents indicating that it purchased the 1993 COLI policies in order to provide a source for funding its Winn-Flex obligations. Unlike the policies used to fund petitioner's obligations under its Management Security Program, the individual 1993 COLI policies were not tailored to fund benefits due the insured employees under Winn-Flex. Indeed, the policies were to remain in effect after the individual employees left petitioner's employ. In planning for and setting up the COLI plan, petitioner's financial vice president and principal financial officer, Mr. McCook, never told the individuals at WJ/Coventry, who were planing the COLI transactions, about any purpose or objective to use the COLI plan to fund benefits under Winn-Flex.

On brief, petitioner argues that death benefits and policy loans and withdrawals from the net cash value of COLI policies could be used to help fund Winn-Flex. However, the projections, which embody petitioner's broad-based COLI plan, show that anticipated death benefits and net cash val-

ues were going to be exhausted in order to satisfy petitioner's premiums and policy loan interest obligations. According to petitioner's COLI plan, there would be no death benefits and cash value left over to provide the necessary funding for Winn-Flex. Indeed, the COLI plan anticipated that after using available death benefits, policy loan proceeds, and withdrawals, petitioner would still be required to make annual cash payments in order to satisfy its annual premium and policy loan interest obligations. We do not believe that petitioner purchased the COLI policies to fund Winn-Flex.

In his testimony, Mr. McCook made it clear that his focus was on the bottom line, after-tax earnings impact, of the COLI plan and the resulting positive cash-flow that the tax deductions were expected to generate. Referring to the January 27, 1993, projections of profit and loss prepared by Coventry (appendix A), Mr. McCook testified that he expected that by the 15th year the annual financial benefit of the COLI transaction would offset the annual costs of petitioner's Winn-Flex obligations. According to the January 27, 1993, projection of profit and loss (appendix A), there was a pretax loss in each year of the 60 years in the projection. The pretax loss for the 15th year (2007) was $14,178,000, and the cumulative pretax loss for the first 15 years was $148,483,000. The January 27, 1993, projection of profit and loss showed a profit for the year 2007 only after considering the tax savings from the policy loan interest and fee deductions. The projected after-tax profit from the COLI plan for 2007 was $64,479,000. When Mr. McCook identified the amount he believed would be available to fund the annual costs of Winn-Flex, he referred to the $64,479,000 amount of projected after-tax earnings from the COLI program for the year 2007. This amount was produced by loan interest and fee deductions. A tax savings generated by the COLI plan was the only reason the plan produced positive earnings and

cash-flow. Indeed, petitioner's internal records show that petitioner viewed the 1993 COLI plan as an "Expense Reduction Opportunity", that would produce estimated savings of $300 million.[44] The only "expense" that was reduced by the COLI plan was petitioner's income tax liability.

Even if we were to accept Mr. McCook's testimony that he intended to use tax savings to fund Winn-Flex, that would not cause the COLI plan to have economic substance.[45] If this were sufficient to breathe substance into a transaction whose only purpose was to reduce taxes, every sham tax-shelter device might succeed. Petitioner's benefit from the COLI plan was dependent on the projected interest and fee deductions that would offset income from petitioner's normal operations. The possibility that such tax benefits could have been used as a general source of funds for petitioner's Winn-Flex obligations (or any other business purpose) does not alter the fact that the COLI plan itself had only one function and that was to generate tax deductions which were to be used to offset income from its business and thereby reduce petitioner's income tax liabilities in each year.

Petitioner also argues that the purchase of the COLI policies permitted it to increase group life benefits offered to Winn-Flex participants. It is true that petitioner offered an

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[44] When Mr. McCook was asked how the $300 million was derived, he testified that he thought that it was the total of the "After-tax Savings" figures listed in the Jan. 27, 1993, projections. These Jan. 27, 1993, projections are contained in appendix A, Profit and Loss Statement. The after-tax earnings referred to by Mr. McCook are in column J. The total after-tax earnings for the policy years 1993 through 2007 are slightly more than $300 million. The total projected after-tax earnings for the years 1993 through 2052 are more than $2 billion.

[45] We note that none of these tax savings were earmarked for funding Winn-Flex. They were simply projected to reduce petitioner's tax liabilities and thereby increase petitioner's after-tax profits by more than $2 billion over 60 years.

additional $5,000 in life insurance benefits to employees who agreed to allow petitioner to purchase COLI policies on their lives. However, this was done at the suggestion of Coventry in order to obtain the employees' consent to have their lives insured. There was no relationship between death benefits under the COLI policies and the relatively small $5,000 employee death benefit. All policies bore a $3,000 annual premium, and death benefits under the policies were based on that premium amount and the age of the employee. Also, petitioner had a high turnover among its employees, and the $5,000 death benefit expired when the insured's employment with petitioner ended. As a result, Coventry advised petitioner that the additional $5,000 in coverage could be provided at an insignificant cost. Based on the record, we do not believe that the purpose of the COLI plan was to fund employee benefits.

Petitioner's COLI plan required a relatively small amount of cash investment by petitioner and charged a high rate of interest on petitioner's policy loans based on the assumption that petitioner's "appetite for interest deductions remains large". The projections showed that the COLI plan would generate positive cash-flows and earnings only because of the tax benefit associated with the interest and fee deductions. Tax considerations permeated the planning stages of petitioner's COLI. When the broad-based COLI plan was first explained to him, Mr. McCook recognized that it was a tax shelter. Mr. McCook's primary concern was to achieve a positive cash-flow. The only way a positive cash-flow could be achieved was through the deduction of interest on policy loans. This is why petitioner concentrated on its ability to deduct loan interest and the availability of "exit strategies" in the event new legal restrictions on deductions were enacted or petitioner's "appetite" for interest deductions diminished.

Following the enactment of tax law changes in August 1996, which greatly restricted employers' deductions for interest on loans from company-owned life insurance policies on the lives of employees, petitioner terminated its COLI program. See Health Insurance Portability and Accountability Act of 1996, Pub. L. 104-191, sec. 501, 110 Stat. 2090. The 1996 change in the tax law caused petitioner's COLI program to become a financial burden because it specifically prohibited the deduction of policy loan interest under petitioner's plan. After the 1996 tax law change, none of petitioner's purported business purposes affected petitioner's decision to terminate the COLI program.

Petitioner cites *Campbell v. Cen-Tex, Inc.*, 377 F.2d 688 (5th Cir. 1967), as controlling precedent in this case.[46] Petitioner's reliance on this case is misplaced. Cen-Tex was a family-owned corporation that had entered into deferred compensation arrangements, which obligated it to provide payments to the surviving spouse or lineal descendants of employee stockholders and to purchase and redeem stock of deceased stockholders. Cen-Tex decided to meet these obligations by purchasing insurance on the lives of the employee stockholders. Cen-Tex paid the first annual premium on each policy and prepaid the next four annual premiums, discounted at 3 percent, and then borrowed against the value on each of the policies at a 4-percent rate. See *Id.* at 689. The court allowed deductions for interest on the policy loans.

Cen-Tex, Inc. is clearly distinguishable from petitioner's case. The parties in *Cen-Tex, Inc.* stipulated that the insur-

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[46] Petitioner's case is appealable to the Court of Appeals for the Eleventh Circuit. Decisions of the Court of Appeals for the Fifth Circuit that were handed down prior to Sept. 30, 1981, are generally binding as precedent in the Eleventh Circuit. *Bonner v. City of Prichard*, 661 F.2d 1206 (11th Cir. 1981).

ance policies at issue were procured to assist in meeting the obligations of the taxpayer under its deferred compensation plan and its obligations under the stock option and redemption agreement, as well as for the general objective of having insurance on its key employees and stockholders. Based on this concession, the court found there was a bona fide nontax business purpose and economic objective to be served by the insurance. See *id.* The court also found that the transaction produced benefits other than tax benefits. The court concluded that "The policies purchased provided for a beneficial interest. The transaction was not without economic value, economic significance, economic substance, or commercial substance." *Campbell v. Cen-Tex, Inc.*, *supra* at 692 (fn. refs. omitted).

In contrast to *Campbell v. Cen-Tex, Inc.*, *supra*, we have found that no nontax purpose was served by the COLI transactions. The projections for the COLI policies contemplated a substantial pretax loss in each year, even after considering the projected death benefits and net cash surrender value of the policies. Only by deducting the policy loan interest and fees and reducing its income tax could petitioner anticipate any benefit from its COLI transactions. Without the tax benefits of the policy loan interest and fee deductions being generated by the COLI plan, petitioner's plan would have generated a predictable negative cash-flow and pretax loss in each of the 60 years projected. This predictable result precludes any economic value, economic significance, economic substance, or commercial substance other than the tax benefit.

Based upon all the aforementioned considerations, we find that petitioner purchased the COLI policies in 1993 pursuant to a plan the only function of which was to generate interest and fee deductions in order to offset income from other sources and thereby significantly reduce its income tax

liability. We hold that petitioner's 1993 broad-based COLI program lacked substance and was a sham.

Petitioner argues that lack of economic substance does not warrant disallowing the interest deduction in question because deductions for interest on life insurance policy loans were condoned by Congress as indicated by the safe harbor test of section 264 and its legislative history. Petitioner argues that the legislative history shows that Congress clearly accepted the deductibility of interest on corporate-owned life insurance products that satisfy the safe harbor tests of section 264. Petitioner maintains that because its COLI policies were life insurance contracts within the meaning of section 7702 and its pattern of borrowing from the policies satisfied the "four-of-seven test" of section 264(c)(1), its loan interest is deductible under section 163. Petitioner also argues that because Congress, through legislation in 1996, further extended its denial of deductions associated with interest payments on COLI policy loans, petitioner was not barred from taking such deductions prior to 1996.

Section 264(a)(3) generally provides that no deduction is allowed for amounts paid or accrued on indebtedness incurred to purchase a life insurance contract if such debt was incurred pursuant to a plan of purchase which contemplates the systematic borrowing of increases in the cash value of the insurance contract. Section 264(c)(1) provides an exception to the general rule under section 264(a)(3). Section 264(c)(1) provides that if no part of any four annual premiums due in the first 7-year period of an insurance contract is financed by means of indebtedness, then the general rule of section 264(a)(3) will not apply.[47]

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[47] In pertinent part, sec. 264(a) provides:

SEC. 264(a) General Rule. — No deduction shall be allowed for —

The parties refer to this exception as the "four-of-seven test". The parties agree that petitioner's COLI policies meet the requirements of the four-of-seven test.[48] The parties disagree as to whether satisfaction of the requirements of section 264(a) and (c) authorizes a deduction of the interest ex-

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(Continued...)

* * * * *

(3) Except as provided in subsection (c), any amount paid or accrued on indebtedness incurred or continued to purchase or carry a life insurance, endowment, or annuity contract (other than a single premium contract or a contract treated as a single premium contract) pursuant to a plan of purchase which contemplates the systematic direct or indirect borrowing of part or all of the increases in the cash value of such contract (either from the insurer or otherwise).

* * * * *

(c) Exceptions. — Subsection (a)(3) shall not apply to any amount paid or accrued by a person during a taxable year on indebtedness incurred or continued as part of a plan referred to in subsection (a)(3) —

(1) if no part of 4 of the annual premiums due during the 7-year period (beginning with the date the first premium on the contract to which such plan relates was paid) is paid under such plan by means of indebtedness,

(2) if the total of the amounts paid or accrued by such person during such taxable year for which (without regard to this paragraph) no deduction would be allowable by reason of subsection (a)(3) does not exceed $100,

(3) if such amount was paid or accrued on indebtedness incurred because of an unforeseen substantial loss of income or unforeseen substantial increase in his financial obligations, or

(4) if such indebtedness was incurred in connection with his trade or business.

For purposes of applying paragraph (1), if there is a substantial increase in the premiums on a contract, a new 7-year period described in such paragraph with respect to such contract shall commence on the date the first such increased premium is paid.

[48] The parties also agree that petitioner's COLI policies meet the definition of a life insurance contract for purposes of sec. 7702.

penses arising out of a transaction that otherwise is without substance.

An argument similar to petitioner's was made in *Knetsch v. United States*, 364 U.S. 361, (1960). In *Knetsch*, the Court found that the taxpayer's purchase of annuity contracts and simultaneous loans from an insurance company was a sham that did not give rise to deductible interest. Nevertheless, like petitioner, the taxpayer in *Knetsch* contended that by enacting section 264 as part of the 1954 Code, Congress "authorized" the interest deductions for transactions prior to the effective date of the 1954 Code. See *id.* at 367. Section 264(a)(2), as enacted in 1954, denied a deduction for amounts paid on indebtedness incurred to purchase or carry a single premium annuity contract, but only as to contracts purchased after March 1, 1954, the date of enactment. See *id.* From this the taxpayers reasoned that Congress intended to allow interest deductions for such transactions occurring prior to March 1, 1954, regardless of their substance. The Supreme Court disagreed, concluding that unless such meaning plainly appeared from the statute and its legislative history, the Court would not attribute such an intent to Congress, for "'To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose.'" *Id.* (quoting *Gregory v. Helvering*, 293 U.S. at 470).

A taxpayer's right to a deduction for interest on an insurance policy loan is based on section 163, not section 264. *Golsen v. Commissioner*, 54 T.C. 742, 755 (1970), affd. 445 F.2d 985 (10th Cir. 1971). Section 264 does not confer the right to a deduction but simply denies, disallows, or prohibits deductions that might otherwise be allowable under some other provision. *See id.* at 756. Thus, while the parties agree that petitioner's COLI plan meets the "four-of-seven test" of section 264(c)(1) and would be excepted from the general

disallowance rule of section 264(a)(3), section 264 does not confer a right upon petitioner to take the deduction that would not otherwise be allowable under section 163.

Petitioner cites the Senate Finance Committee's report discussing the scope of section 264 prior to the 1964 amendment. The report states that "under present law, no interest deductions are denied where the taxpayer purchases an insurance contract with the intention of borrowing the maximum amount on the contract each year". S. Rept. 830, 88th Cong., 2d Sess. (1964), 1964-1 C.B. (Part 2) 505, 581. Based on this, petitioner argues that Congress did not view the Supreme Court's decision in *Knetsch* as foreclosing interest deductions based on the type of sham transactions involved in this case. A similar argument was advanced in *McLane v. Commissioner*, 46 T.C. 140 (1966), affd. 377 F.2d 557 (9th Cir. 1967), where the taxpayers had engaged in a series of transactions similar to those in the instant case. In the Revenue Act of 1964, Pub. L. 88-272, sec. 215(a), 78 Stat. 55, Congress added subsection (a)(3) of section 264 to address problems associated with amounts paid or accrued on indebtedness incurred with respect to several types of insurance contracts pursuant to a plan of systematic borrowing. In *McLane v. Commissioner*, *supra* 46 T.C. at 144-145, we considered the same passage from the Senate Finance Committee report that petitioner cites and stated:

> Based upon the foregoing, petitioner by a tour de force concludes that: (a) The 1958 transaction herein is the type of abuse meant to be curbed by subsection (a)(3), but only prospectively; (b) the legislative history expressly confirms his assertion that the deduction flowing from this abuse was allowable under prior law; and (c) the 'interest' involved herein is therefore deductible.

> We agree with petitioners that the 1958 transaction *in form* fell within the class of transactions at which subsection (a)(3) was aimed. But we do not agree with his assertion that the legislative history should be turned into an open-ended license applicable without regard to the substance of the transaction. Nor do we agree with the assertion that, if *Knetsch* and *Pierce*, were controlling with respect to post-1958 multiple-premium annuities, there would have been no need for further legislation in 1964. *Knetsch* and *Pierce* involved transactions without substance. Congress, in enacting section 264(a)(3), struck at transactions *with* substance. It is a *reductio ad absurdum* to reason, as petitioner does, that Congress simultaneously struck down a warm body and breathed life into petitioner's cadaver. [Fn. ref. omitted.]

Petitioner attempts to supplement its argument by citing additional legislative materials related to changes or proposed changes to section 264 in 1984, 1986, 1987, 1988, 1990, 1991, and 1996. We need not address each of the changes and proposals regarding interest deductions on life insurance policy loans. It is clear that Congress and the Treasury Department were aware of the problems associated with interest deductions on life insurance loans. However, we are not persuaded that Congress, by enacting and amending section 264 or other related provisions that *restrict* the deductibility of interest, intended to *allow* interest deductions under section 163 based on transactions that lacked either economic substance or business purpose. In *Knetsch*, the Supreme Court noted that nothing in the legislative history of section 264 suggests that Congress intended to protect sham transactions. Similarly, we find nothing in the more recent legis-

lative history of section 264 suggesting that Congress intended to allow deductions arising from sham transactions that lacked economic substance and business purpose.

The transactions associated with petitioner's COLI program lacked economic substance and business purpose (other than tax reduction). As a result, the interest on petitioner's COLI loans was not deductible interest on indebtedness within the meaning of section 163. The same reasoning applies to the administrative fees associated with the COLI plan.[49] They were incurred in connection with, and were an integral part of, a sham transaction and, as a result, are not deductible. See Karr v. Commissioner, 924 F.2d at 1022-1023; *Kirchman v. Commissioner*, 862 F.2d 1486; *Lee v. Commissioner*, 155 F.3d 584 (2d Cir. 1998). We, therefore, uphold respondent's disallowance of these deductions.

Decision will be entered under Rule 155.

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[49] Respondent argues that the administrative fees should be disallowed pursuant to sec. 265. Because we have held that the administrative fees must be disallowed as the product of a sham, we have no need to consider disallowance under sec. 265.

THE APPENDIX TO THE TAX COURT'S OPINION IS LODGED SEPARATELY WITH THE COURT

IN THE UNITED STATES COURT OF APPEALS
FOR THE ELEVENTH CIRCUIT

No. 00-11828-JJ

WINN-DIXIE STORES., INC. AND SUBSIDIARIES,

PETITIONER-APPELLANT,

v.

COMMISSIONER OF INTERNAL REVENUE,

RESPONDENT-APPELLEE.

ON APPEAL FROM A DECISION OF
THE UNITED STATES TAX COURT

ON PETITION(S) FOR REHEARING AND
PETITION(S) FOR REHEARING EN BANC
(OPINION____, 11TH CIR., 19_, __F.2D__).

[FILED: SEPT. 28, 2001]

BEFORE:

WILSON, CIRCUIT JUDGE
COX, CIRCUIT JUDGES,
RYSKAMP*, DISTRICT JUDGE.

PER CURIAM:

The Petition(s) for Rehearing are DENIED and no member of this panel nor other Judge in regular active service on the Court having requested that the Court be polled on rehearing en banc (Rule 35, Federal Rules of Appellate Procedure; Eleventh Circuit Rule 35-5), the Petition(s) for Rehearing En Banc are DENIED.

ENTERED FOR THE COURT:

/s/UNITED STATES CIRCUIT JUDGE

*Honorable Kenneth L. Ryskamp, U. S. District Judge for the Southern District of Florida, sitting by designation.

STATUTORY PROVISIONS

I.R.C. § 163 (1993)

§ 163. Interest

(a) General rule.—There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

(b) Installment purchases where interest charge is not separately stated.—

(1) General rule.—If personal property or educational services are purchased under a contract—

(A) which provides that payment of part or all of the purchase price is to be made in installments, and

(B) in which carrying charges are separately stated but the interest charge cannot be ascertained, then the payments made during the taxable year under the contract shall be treated for purposes of this section as if they included interest equal to 6 percent of the average unpaid balance under the contract during the taxable year. For purposes of the preceding sentence, the average unpaid balance is the sum of the unpaid balance outstanding on the first day of each month beginning during the taxable year, divided by 12. For purposes of this paragraph, the term "educational services" means any service (including lodging) which is purchased from an educational organization described in section 170(b)(1)(A)(ii) and which is provided for a student of such organization.

(2) Limitation.—In the case of any contract to which paragraph (1) applies, the amount treated as interest

for any taxable year shall not exceed the aggregate carrying charges which are properly attributable to such taxable year.

(c) **Redeemable ground rents.**—For purposes of this subtitle, any annual or periodic rental under a redeemable ground rent (excluding amounts in redemption thereof) shall be treated as interest on an indebtedness secured by a mortgage.

(d) **Limitation on investment interest.**—

(1) **In general.**—In the case of a taxpayer other than a corporation, the amount allowed as a deduction under this chapter for investment interest for any taxable year shall not exceed the net investment income of the taxpayer for the taxable year.

(2) **Carryforward of disallowed interest.**—The amount not allowed as a deduction for any taxable year by reason of paragraph (1) shall be treated as investment interest paid or accrued by the taxpayer in the succeeding taxable year.

(3) **Investment interest.**—For purposes of this subsection—

(A) **In general.**—The term "investment interest" means any interest allowable as a deduction under this chapter (determined without regard to paragraph (1)) which is paid or accrued on indebtedness properly allocable to property held for investment.

(B) **Exceptions.**—The term "investment interest" shall not include—

(i) any qualified residence interest (as defined in subsection (h)(3)), or

(ii) any interest which is taken into account under section 469 in computing income or loss from a passive activity of the taxpayer.

(C) **Personal property used in short sale.**—For purposes of this paragraph, the term "interest" includes any amount allowable as a deduction in connection with personal property used in a short sale.

(4) **Net investment income.**—For purposes of this subsection—

(A) **In general.**—The term "net investment income" means the excess of—

(i) investment income, over

(ii) investment expenses.

(B) **Investment income.**—The term "investment income" means the sum of—

(i) gross income (other than gain taken into account under clause (ii)) from property held for investment, and

(ii) any net gain attributable to the disposition of property held for investment.

(C) **Investment expenses.**—The term "investment expenses" means the deductions allowed under this chapter (other than for interest) which are directly connected with the production of investment income.

(D) **Income and expenses from passive activities.**—Investment income and investment expenses shall not include any income or expenses taken into account under section 469 in computing income or loss from a passive activity.

(E) Reduction in investment income during phase-in of passive loss rules.— Investment income of the taxpayer for any taxable year shall be reduced by the amount of the passive activity loss to which section 469(a) does not apply for such taxable year by reason of section 469(m). The preceding sentence shall not apply to any portion of such passive activity loss which is attributable to a rental real estate activity with respect to which the taxpayer actively participates (within the meaning of section 469(i)(6)) during such taxable year.

(5) Property held for investment.—For purposes of this subsection—

(A) In general.—The term "property held for investment" shall include—

(i) any property which produces income of a type described in section 469(e)(1), and

(ii) any interest held by a taxpayer in an activity involving the conduct of a trade or business—

(I) which is not a passive activity, and

(II) with respect to which the taxpayer does not materially participate.

(B) Investment expenses.—In the case of property described in subparagraph (A)(i), expenses shall be allocated to such property in the same manner as under section 469.

(C) Terms.—For purposes of this paragraph, the terms "activity", "passive activity", and "materially participate" have the meanings given such terms by section 469.

(6) Phase-in of disallowance.—In the case of any taxable year beginning in calendar years 1987 through 1990—

(A) In general.—The amount of interest paid or accrued during any such taxable year which is disallowed under this subsection shall not exceed the sum of—

(i) the amount which would be disallowed under this subsection if—

(I) paragraph (1) were applied by substituting "the sum of the ceiling amount and the net investment income" for "the net investment income", and

(II) paragraphs (4)(E) and (5)(A)(ii) did not apply, and

(ii) the applicable percentage of the excess of—

(I) the amount which (without regard to this paragraph) is not allowable as a deduction under this subsection for the taxable year, over

(II) the amount described in clause (i).

The preceding sentence shall not apply to any interest treated as paid or accrued during the taxable year under paragraph (2).

(B) Applicable percentage.—For purposes of this paragraph, the applicable percentage shall be determined in accordance with the following table:

In the case of taxable years beginning in:	The applicable percentage is:
1987	35
1988	60

1989	80
1990	90

(C) Ceiling amount.—For purposes of this paragraph, the term "ceiling amount" means—

(i) $10,000 in the case of a taxpayer not described in clause (ii) or (iii),

(ii) $5,000 in the case of a married individual filing a separate return, and

(iii) zero in the case of a trust.

(e) Original issue discount.—

(1) In general.—In the case of any debt instrument issued after July 1, 1982, the portion of the original issue discount with respect to such debt instrument which is allowable as a deduction to the issuer for any taxable year shall be equal to the aggregate daily portions of the original issue discount for days during such taxable year.

(2) Definitions and special rules.—For purposes of this subsection—

(A) Debt instrument.—The term "debt instrument" has the meaning given such term by section 1275(a)(1).

(B) Daily portions.—The daily portion of the original issue discount for any day shall be determined under section 1272(a) (without regard to paragraph (7) thereof and without regard to section 1273(a)(3)).

(C) Short-term obligations.—In the case of an obligor of a short-term obligation (as defined in section 1283(a)(1)(A)) who uses the cash receipts and disbursements method of accounting, the original

issue discount (and any other interest payable) on such obligation shall be deductible only when paid.

(3) **Special rule for original issue discount on obligation held by related** foreign person.—

(A) **In general.**—If any debt instrument having original issue discount is held by a related foreign person, any portion of such original issue discount shall not be allowable as a deduction to the issuer until paid. The preceding sentence shall not apply to the extent that the original issue discount is effectively connected with the conduct by such foreign related person of a trade or business within the United States unless such original issue discount is exempt from taxation (or is subject to a reduced rate of tax) pursuant to a treaty obligation of the United States.

(B) **Related foreign person.**—For purposes of subparagraph (A), the term "related foreign person" means any person—

(i) who is not a United States person, and

(ii) who is related (within the meaning of section 267(b)) to the issuer.

(4) **Exceptions.**—This subsection shall not apply to any debt instrument described in—

(A) subparagraph (D) of section 1272(a)(2) (relating to obligations issued by natural persons before March 2, 1984), and

(B) subparagraph (E) of section 1272(a)(2) (relating to loans between natural persons).

(5) Special rules for original issue discount on certain high yield obligations.—

(A) In general.—In the case of an applicable high yield discount obligation issued by a corporation—

(i) no deduction shall be allowed under this chapter for the disqualified portion of the original issue discount on such obligation, and

(ii) the remainder of such original issue discount shall not be allowable as a deduction until paid.

For purposes of this paragraph, rules similar to the rules of subsection (i)(3)(B) shall apply in determining the amount of the original issue discount and when the original issue discount is paid.

(B) Disqualified portion treated as stock distribution for purposes of dividend received deduction.—

(i) In general.—Solely for purposes of sections 243, 245, 246, and 246A, the dividend equivalent portion of any amount includible in gross income of a corporation under section 1272(a) in respect of an applicable high yield discount obligation shall be treated as a dividend received by such corporation from the corporation issuing such obligation.

(ii) Dividend equivalent portion.—For purposes of clause (i), the dividend equivalent portion of any amount includible in gross income under section 1272(a) in respect of an applicable high yield discount obligation is the portion of the amount so includible—

(I) which is attributable to the disqualified portion of the original issue discount on such obligation, and

(II) which would have been treated as a dividend if it had been a distribution made by the issuing corporation with respect to stock in such corporation.

(C) Disqualified portion.—

(i) In general.—For purposes of this paragraph, the disqualified portion of the original issue discount on any applicable high yield discount obligation is the lesser of—

(I) the amount of such original issue discount, or

(II) the portion of the total return on such obligation which bears the same ratio to such total return as the disqualified yield on such obligation bears to the yield to maturity on such obligation.

(ii) Definitions.—For purposes of clause (i), the term "disqualified yield" means the excess of the yield to maturity on the obligation over the sum referred to subsection (i)(1)(B) plus 1 percentage point, and the term "total return" is the amount which would have been the original issue discount on the obligation if interest described in the parenthetical in section 1273(a)(2) were included in the stated redemption price at maturity.

(D) Exception for S corporations.—This paragraph shall not apply to any obligation issued by any

corporation for any period for which such corporation is an S corporation.

(E) Effect on earnings and profits.—This paragraph shall not apply for purposes of determining earnings and profits; except that, for purposes of determining the dividend equivalent portion of any amount includible in gross income under section 1272(a) in respect of an applicable high yield discount obligation, no reduction shall be made for any amount attributable to the disqualified portion of any original issue discount on such obligation.

(F) Cross reference.— For definition of applicable high yield discount obligation, see subsection (i).

(6) Cross references.—

For provision relating to deduction of original issue discount on tax-exempt obligation, see section 1288.

For special rules in the case of the borrower under certain loans for personal use, **see section 1275(b).**

(f) Denial of deduction for interest on certain obligations not in registered form.—

(1) In general.—Nothing in subsection (a) or in any other provision of law shall be construed to provide a deduction for interest on any registration- required obligation unless such obligation is in registered form.

(2) Registration-required obligation.—For purposes of this section—

(A) In general.—The term "registration-required obligation" means any obligation (including any obligation issued by a governmental entity) other than an obligation which—

(i) is issued by a natural person,

(ii) is not of a type offered to the public,

(iii) has a maturity (at issue) of not more than 1 year, or

(iv) is described in subparagraph (B).

(B) Certain obligations not included.—An obligation is described in this subparagraph if—

(i) there are arrangements reasonably designed to ensure that such obligation will be sold (or resold in connection with the original issue)only to a person who is not a United States person, and

(ii) in the case of an obligation not in registered form—

(I) interest on such obligation is payable only outside the United States and its possessions, and

(II) on the face of such obligation there is a statement that any United States person who holds such obligation will be subject to limitations under the United States income tax laws.

(C) Authority to include other obligations.—Clauses (ii) and (iii) of subparagraph (A), and subparagraph (B), shall not apply to any obligation if—

(i) in the case of—

(I) subparagraph (A), such obligation is of a type which the Secretary has determined

by regulations to be used frequently in avoiding Federal taxes, or

(II) subparagraph (B), such obligation is of a type specified by the Secretary in regulations, and

(ii) such obligation is issued after the date on which the regulations referred to in clause (i) take effect.

(3) **Book entries permitted, etc.**—For purposes of this subsection, rules similar to the rules of section 149(a)(3) shall apply.

(g) **Reduction of deduction where section 25 credit taken.**—The amount of the deduction under this section for interest paid or accrued during any taxable year on indebtedness with respect to which a mortgage credit certificate has been issued under section 25 shall be reduced by the amount of the credit allowable with respect to such interest under section 25 (determined without regard to section 26).

(h) **Disallowance of deduction for personal interest.**—

(1) **In general.**—In the case of a taxpayer other than a corporation, no deduction shall be allowed under this chapter for personal interest paid or accrued during the taxable year.

(2) **Personal interest.**—For purposes of this subsection, the term "personal interest" means any interest allowable as a deduction under this chapter other than—

(A) interest paid or accrued on indebtedness properly allocable to a trade or business (other than the trade or business of performing services as an employee),

(B) any investment interest (within the meaning of subsection (d)),

(C) any interest which is taken into account under section 469 in computing income or loss from a passive activity of the taxpayer,

(D) any qualified residence interest (within the meaning of paragraph (3)), and

(E) any interest payable under section 6601 on any unpaid portion of the tax imposed by section 2001 for the period during which an extension of time for payment of such tax is in effect under section 6163 or 6166 or under section 6166A (as in effect before its repeal by the Economic Recovery Tax Act of 1981).

(3) **Qualified residence interest.**—For purposes of this subsection—

(A) **In general.**—The term "qualified residence interest" means any interest which is paid or accrued during the taxable year on—

(i) acquisition indebtedness with respect to any qualified residence of the taxpayer, or

(ii) home equity indebtedness with respect to any qualified residence of the taxpayer.

For purposes of the preceding sentence, the determination of whether any property is a qualified residence of the taxpayer shall be made as of the time the interest is accrued.

(B) **Acquisition indebtedness.**—

(i) **In general.**—The term "acquisition indebtedness" means any indebtedness which—

(I) is incurred in acquiring, constructing, or substantially improving any qualified residence of the taxpayer, and

(II) is secured by such residence. Such term also includes any indebtedness secured by such residence resulting from the refinancing of indebtedness meeting the requirements of the preceding sentence (or this sentence); but only to the extent the amount of the indebtedness resulting from such refinancing does not exceed the amount of the refinanced indebtedness.

(ii) **$1,000,000 Limitation.**—The aggregate amount treated as acquisition indebtedness for any period shall not exceed $1,000,000 ($500,000 in the case of a married individual filing a separate return).

(C) Home equity indebtedness.—

(i) **In general.**—The term "home equity indebtedness" means any indebtedness (other than acquisition indebtedness) secured by a qualified residence to the extent the aggregate amount of such indebtedness does not exceed—

(I) the fair market value of such qualified residence, reduced by

(II) the amount of acquisition indebtedness with respect to such residence.

(ii) **Limitation.**—The aggregate amount treated as home equity indebtedness for any period shall not exceed $100,000 ($50,000 in the case of a separate return by a married individual).

(D) Treatment of indebtedness incurred on or before October 13, 1987.—

(i) In general.—In the case of any pre-October 13, 1987, indebtedness—

(I) such indebtedness shall be treated as acquisition indebtedness, and

(II) the limitation of subparagraph (B)(ii) shall not apply.

(ii) Reduction in $1,000,000 Limitation.—The limitation of subparagraph (B)(ii) shall be reduced (but not below zero) by the aggregate amount of outstanding pre-October 13, 1987, indebtedness.

(iii) Pre-October 13, 1987, indebtedness.—The term "pre-October 13, 1987, indebtedness" means—

(I) any indebtedness which was incurred on or before October 13, 1987, and which was secured by a qualified residence on October 13, 1987, and at all times thereafter before the interest is paid or accrued, or

(II) any indebtedness which is secured by the qualified residence and was incurred after October 13, 1987, to refinance indebtedness described in subclause (I) (or refinanced indebtedness meeting the requirements of this subclause) to the extent (immediately after the refinancing) the principal amount of the indebtedness resulting from the refinancing does not exceed the principal amount of the refi-

nanced indebtedness (immediately before the refinancing).

(iv) **Limitation on period of refinancing.**—Subclause (II) of clause (iii) shall not apply to any indebtedness after—

(I) the expiration of the term of the indebtedness described in clause (iii)(I), or

(II) if the principal of the indebtedness described in clause (iii)(I) is not amortized over its term, the expiration of the term of the 1st refinancing of such indebtedness (or if earlier, the date which is 30 years after the date of such 1st refinancing).

(4) **Other definitions and special rules.**—For purposes of this subsection—

(A) **Qualified residence.**—

(i) **In general.**—The term "qualified residence" means—

(I) the principal residence (within the meaning of section 1034) of the taxpayer, and

(II) 1 other residence of the taxpayer which is selected by the taxpayer for purposes of this subsection for the taxable year and which is used by the taxpayer as a residence (within the meaning of section 280A(d)(1)).

(ii) **Married individuals filing separate returns.**—If a married couple does not file a joint return for the taxable year—

(I) such couple shall be treated as 1 taxpayer for purposes of clause (i), and

(II) each individual shall be entitled to take into account 1 residence unless both individuals consent in writing to 1 individual taking into account the principal residence and 1 other residence.

(iii) **Residence not rented.**—For purposes of clause (i)(II), notwithstanding section 280A(d)(1), if the taxpayer does not rent a dwelling unit at any time during a taxable year, such unit may be treated as a residence for such taxable year.

(B) **Special rule for cooperative housing corporations.**—Any indebtedness secured by stock held by the taxpayer as a tenant-stockholder (as defined in section 216) in a cooperative housing corporation (as so defined) shall be treated as secured by the house or apartment which the taxpayer is entitled to occupy as such a tenant-stockholder. If stock described in the preceding sentence may not be used to secure indebtedness, indebtedness shall be treated as so secured if the taxpayer establishes to the satisfaction of the Secretary that such indebtedness was incurred to acquire such stock.

(C) **Unenforceable security interests.**—Indebtedness shall not fail to be treated as secured by any property solely because, under any applicable State or local homestead or other debtor protection law in effect on August 16, 1986, the security interest is ineffective or the enforceability of the security interest is restricted.

(D) **Special rules for estates and trusts.**—For purposes of determining whether any interest paid or

accrued by an estate or trust is qualified residence interest, any residence held by such estate or trust shall be treated as a qualified residence of such estate or trust if such estate or trust establishes that such residence is a qualified residence of a beneficiary who has a present interest in such estate or trust or an interest in the residuary of such estate or trust.

(5) **Phase-in of limitation.**—In the case of any taxable year beginning in calendar years 1987 through 1990, the amount of interest with respect to which a deduction is disallowed under this subsection shall be equal to the applicable percentage (within the meaning of subsection (d)(6)(B)) of the amount which (but for this paragraph) would have been so disallowed.

(i) Applicable high yield discount obligation.—

(1) **In general.**—For purposes of this section, the term "applicable high yield discount obligation" means any debt instrument if—

(A) the maturity date of such instrument is more than 5 years from the date of issue,

(B) the yield to maturity on such instrument equals or exceeds the sum of—

(i) the applicable Federal rate in effect under section 1274(d) for the calendar month in which the obligation is issued, plus

(ii) 5 percentage points, and

(C) such instrument has significant original issue discount. For purposes of subparagraph (B)(i), the Secretary may by regulation permit a rate to be used with respect to any debt instrument which is higher than the applicable Federal rate if the tax-

payer establishes to the satisfaction of the Secretary that such higher rate is based on the same principles as the applicable Federal rate and is appropriate for the term of the instrument.

(2) Significant original issue discount.—For purposes of paragraph (1)(C), a debt instrument shall be treated as having significant original issue discount if—

(A) the aggregate amount which would be includible in gross income with respect to such instrument for periods before the close of any accrual period (as defined in section 1272(a)(5)) ending after the date 5 years after the date of issue, exceeds—

(B) the sum of—

(i) the aggregate amount of interest to be paid under the instrument before the close of such accrual period, and

(ii) the product of the issue price of such instrument (as defined in sections 1273(b) and 1274(a)) and its yield to maturity.

(3) Special rules.—For purposes of determining whether a debt instrument is an applicable high yield discount obligation—

(A) any payment under the instrument shall be assumed to be made on the last day permitted under the instrument, and

(B) any payment to be made in the form of another obligation of the issuer (or a related person within the meaning of section 453(f)(1)) shall be assumed to be made when such obligation is required to be paid in cash or in property other than such obligation. Except for purposes of para-

graph (1)(B), any reference to an obligation in subparagraph (B) of this paragraph shall be treated as including a reference to stock.

(4) Debt instrument.—For purposes of this subsection, the term "debt instrument" means any instrument which is a debt instrument as defined in section 1275(a).

(5) Regulations.—The Secretary shall prescribe such regulations as may be appropriate to carry out the purposes of this subsection and subsection (e)(5), including—

(A) regulations providing for modifications to the provisions of this subsection and subsection (e)(5) in the case of varying rates of interest, put or call options, indefinite maturities, contingent payments, assumptions of debt instruments, conversion rights, or other circumstances where such modifications are appropriate to carry out the purposes of this subsection and subsection (e)(5), and

(B) regulations to prevent avoidance of the purposes of this subsection and subsection (e)(5) through the use of issuers other than C corporations, agreements to borrow amounts due under the debt instrument, or other arrangements.

(j) Limitation on deduction for certain interest paid by corporation to related person.—

(1) Limitation.—

(A) In general.—If this subsection applies to any corporation for any taxable year, no deduction shall be allowed under this chapter for disqualified interest paid or accrued by such corporation during such taxable year. The amount disallowed

under the preceding sentence shall not exceed the corporation's excess interest expense for the taxable year.

(B) Disallowed amount carried to succeeding taxable year.—Any amount disallowed under subparagraph (A) for any taxable year shall be treated as disqualified interest paid or accrued in the succeeding taxable year.

(2) Corporations to which subsection applies.—

(A) In general.—This subsection shall apply to any corporation for any taxable year if—

(i) such corporation has excess interest expense for such taxable year, and

(ii) the ratio of debt to equity of such corporation as of the close of such taxable year (or on any other day during the taxable year as the Secretary may by regulations prescribe) exceeds 1.5 to 1.

(B) Excess interest expense.—

(i) In general.—For purposes of this subsection, the term "excess interest expense" means the excess (if any) of—

(I) the corporation's net interest expense, over

(II) the sum of 50 percent of the adjusted taxable income of the corporation plus any excess limitation carryforward under clause (ii).

(ii) Excess limitation carryforward.—If a corporation has an excess limitation for any taxable year, the amount of such excess limita-

tion shall be an excess limitation carryforward to the 1st succeeding taxable year and to the 2nd and 3rd succeeding taxable years to the extent not previously taken into account under this clause. The amount of such a carryforward taken into account for any such succeeding taxable year shall not exceed the excess interest expense for such succeeding taxable year (determined without regard to the carryforward from the taxable year of such excess limitation).

(iii) **Excess limitation.**—For purposes of clause (i), the term "excess limitation" means the excess (if any) of—

(I) 50 percent of the adjusted taxable income of the corporation, over

(II) the corporation's net interest expense.

(C) **Ratio of debt to equity.**—For purposes of this paragraph, the term "ratio of debt to equity" means the ratio which the total indebtedness of the corporation bears to the sum of its money and all other assets reduced (but not below zero) by such total indebtedness. For purposes of the preceding sentence—

(i) the amount taken into account with respect to any asset shall be the adjusted basis thereof for purposes of determining gain,

(ii) the amount taken into account with respect to any indebtedness with original issue discount shall be its issue price plus the portion of the original issue discount previously accrued as determined under the rules of section 1272

(determined without regard to subsection (a)(7) or (b)(4) thereof), and

(iii) there shall be such other adjustments as the Secretary may by regulations prescribe.

(3) Disqualified interest.—For purposes of this subsection—

(A) In general.—Except as provided in subparagraph (B), the term "disqualified interest" means any interest paid or accrued by the taxpayer (directly or indirectly) to a related person if no tax is imposed by this subtitle with respect to such interest.

(B) Exception for certain existing indebtedness.—The term "disqualified interest" does not include any interest paid or accrued under indebtedness with a fixed term—

(i) which was issued on or before July 10, 1989, or

(ii) which was issued after such date pursuant to a written binding contract in effect on such date and all times thereafter before such indebtedness was issued.

(4) Related person.—For purposes of this subsection—

(A) In general.—Except as provided in subparagraph (B), the term "related person" means any person who is related (within the meaning of section 267(b) or 707(b)(1)) to the taxpayer.

(B) Special rule for certain partnerships.—

(i) **In general.**—Any interest paid or accrued to a partnership which (without regard to this subparagraph) is a related person shall not be treated as paid or accrued to a related person

if less than 10 percent of the profits and capital interests in such partnership are held by persons with respect to whom no tax is imposed by this subtitle on such interest. The preceding sentence shall not apply to any interest allocable to any partner in such partnership who is a related person to the taxpayer.

(ii) **Special rule where treaty reduction.**—If any treaty between the United States and any foreign country reduces the rate of tax imposed by this subtitle on a partner's share of any interest paid or accrued to a partnership, such partner's interests in such partnership shall, for purposes of clause (i), be treated as held in part by a tax-exempt person and in part by a taxable person under rules similar to the rules of paragraph (5)(B).

(5) **Special rules for determining whether interest is subject to tax.—**

(A) **Treatment of pass-thru entities.**—In the case of any interest paid or accrued to a partnership, the determination of whether any tax is imposed by this subtitle on such interest shall be made at the partner level. Rules similar to the rules of the preceding sentence shall apply in the case of any pass-thru entity other than a partnership and in the case of tiered partnerships and other entities.

(B) **Interest treated as tax-exempt to extent of treaty reduction.**—If any treaty between the United States and any foreign country reduces the rate of tax imposed by this subtitle on any interest paid or accrued by the taxpayer to a re-

lated person, such interest shallbe treated as interest on which no tax is imposed by this subtitle to the extent of the same proportion of such interest as—

(i) the rate of tax imposed without regard to such treaty, reduced by the rate of tax imposed under the treaty, bears to

(ii) the rate of tax imposed without regard to the treaty.

(6) **Other definitions and special rules.**—For purposes of this subsection—

(A) **Adjusted taxable income.**—The term "adjusted taxable income" means the taxable income of the taxpayer—

(i) computed without regard to—

(I) any deduction allowable under this chapter for the net interest expense.

(II) the amount of any net operating loss deduction under section 172, and

(III) any deduction allowable for depreciation, amortization, or depletion, and

(ii) computed with such other adjustments as the Secretary may by regulations prescribe.

(B) **Net interest expense.**—The term "net interest expense" means the excess (if any) of—

(i) the interest paid or accrued by the taxpayer during the taxable year, over

(ii) the amount of interest includible in the gross income of such taxpayer for such taxable year. The Secretary may by regulations provide for

adjustments in determining the amount of net interest expense.

(C) **Treatment of affiliated group.**—All members of the same affiliated group (within the meaning of section 1504(a)) shall be treated as 1 taxpayer.

(7) **Regulations.**—The Secretary shall prescribe such regulations as may be appropriate to carry out the purposes of this subsection, including—

(A) such regulations as may be appropriate to prevent the avoidance of the purposes of this subsection,

(B) regulations providing such adjustments in the case of corporations which are members of an affiliated group as may be appropriate to carry out the purposes of this subsection, and

(C) regulations for the coordination of this subsection with section 884.

(k) Cross references.—

(1) For disallowance of certain amounts paid in connection with insurance, endowment, or annuity contracts, see section 264.

(2) For disallowance of deduction for interest relating to tax-exempt income, see section 265(a)(2).

(3) For disallowance of deduction for carrying charges chargeable to capital account, see section 266.

(4) For disallowance of interest with respect to transactions between related taxpayers, see section 267.

(5) For treatment of redeemable ground rents and real property held subject to liabilities under redeemable ground rents, see section 1055.

I.R.C. § 264 (1993)

§ 264. Certain amounts paid in connection with insurance contracts.

(a) General rule.—No deduction shall be allowed for—

(1) Premiums paid on any life insurance policy covering the life of any officer or employee, or of any person financially interested in any trade or business carried on by the taxpayer, when the taxpayer is directly or indirectly a beneficiary under such policy.

(2) Any amount paid or accrued on indebtedness incurred or continued to purchase or carry a single premium life insurance, endowment, or annuity contract.

(3) Except as provided in subsection (c), any amount paid or accrued on indebtedness incurred or continued to purchase or carry a life insurance, endowment, or annuity contract (other than a single premium contract or a contract treated as a single premium contract) pursuant to a plan of purchase which contemplates the systematic direct or indirect borrowing of part or all of the increases in the cash value of such contract (either from the insurer or otherwise).

(4) Any interest paid or accrued on any indebtedness with respect to 1 or more life insurance policies owned by the taxpayer covering the life of any individual who—

(A) is an officer or employee of, or

(B) is financially interested in, any trade or business carried on by the taxpayer to the extent that the aggregate amount of such indebtedness with respect to policies covering such individual exceeds $50,000. Paragraph (2) shall apply in respect of

annuity contracts only as to contracts purchased after March 1, 1954. Paragraph (3) shall apply only in respect of contracts purchased after August 6, 1963. Paragraph (4) shall apply with respect to contracts purchased after June 20, 1986.

(b) Contracts treated as single premium contracts.—For purposes of subsection (a)(2), a contract shall be treated as a single premium contract—

(1) if substantially all the premiums on the contract are paid within a period of 4 years from the date on which the contract is purchased, or

(2) if an amount is deposited after March 1, 1954, with the insurer for payment of a substantial number of future premiums on the contract.

(c) Exceptions.—Subsection (a)(3) shall not apply to any amount paid or accrued by a person during a taxable year on indebtedness incurred or continued as part of a plan referred to in subsection (a)(3)—

(1) if no part of 4 of the annual premiums due during the 7-year period (beginning with the date the first premium on the contract to which such plan relates was paid) is paid under such plan by means of indebtedness,

(2) if the total of the amounts paid or accrued by such person during such taxable year for which (without regard to this paragraph) no deduction would be allowable by reason of subsection (a)(3) does not exceed $100,

(3) if such amount was paid or accrued on indebtedness incurred because of an unforeseen substantial loss of income or unforeseen substantial increase in his financial obligations, or

(4) if such indebtedness was incurred in connection with his trade or business.

For purposes of applying paragraph (1), if there is a substantial increase in the premiums on a contract, a new 7-year period described in such paragraph with respect to such contract shall commence on the date the first such increased premium is paid.

I.R.C. § 7702 (1993)

§ 7702. Life insurance contract defined.

(a) General rule.—For purposes of this title, the term "life insurance contract" means any contract which is a life insurance contract under the applicable law, but only if such contract—

(1) meets the cash value accumulation test of subsection (b), or

(2)(A) meets the guideline premium requirements of subsection (c), and

(B) falls within the cash value corridor of subsection (d).

(b) Cash value accumulation test for subsection (a)(1).—

(1) In general.—A contract meets the cash value accumulation test of this subsection if, by the terms of the contract, the cash surrender value of such contract may not at any time exceed the net single premium which would have to be paid at such time to fund future benefits under the contract.

(2) Rules for applying paragraph (1).—Determinations under paragraph (1) shall be made—

(A) on the basis of interest at the greater of an annual effective rate of 4 percent or the rate or rates guaranteed on issuance of the contract,

(B) on the basis of the rules of subparagraph (B)(i) (and, in the case of qualified additional benefits, subparagraph (B)(ii)) of subsection (c)(3), and

(C) by taking into account under subparagraphs (A) and (D) of subsection (e)(1) only current and fu-

ture death benefits and qualified additional benefits.

(c) **Guideline premium requirements.**—For purposes of this section—

(1) **In general.**— A contract meets the guideline premium requirements of this subsection if the sum of the premiums paid under such contract does not at any time exceed the guideline premium limitation as of such time.

(2) **Guideline premium limitation.**—The term "guideline premium limitation" means, as of any date, the greater of—

(A) the guideline single premium, or

(B) the sum of the guideline level premiums to such date.

(3) **Guideline single premium.**—

(A) **In general.**—The term "guideline single premium" means the premium at issue with respect to future benefits under the contract.

(B) **Basis on which determination is made.**—The determination under subparagraph (A) shall be based on—

(i) reasonable mortality charges which meet the requirements (if any) prescribed in regulations and which (except as provided in regulations) do not exceed the mortality charges specified in the prevailing commissioners' standard tables (as defined in section 807(d)(5)) as of the time the contract is issued,

(ii) any reasonable charges (other than mortality charges) which (on the basis of the company's

experience, if any, with respect to similar contracts) are reasonably expected to be actually paid, and

(iii) interest at the greater of an annual effective rate of 6 percent or the rate or rates guaranteed on issuance of the contract.

(C) **When determination made.**—Except as provided in subsection (f)(7), the determination under subparagraph (A) shall be made as of the time the contract is issued.

(D) **Special rules for subparagraph (B)(ii).**—

(i) **Charges not specified in the contract.**—If any charge is not specified in the contract, the amount taken into account under subparagraph (B)(ii) for such charge shall be zero.

(ii) **New companies, etc.**—If any company does not have adequate experience for purposes of the determination under subparagraph (B)(ii), to the extent provided in regulations, such determination shall be made on the basis of the industry-wide experience.

(4) **Guideline level premium.**—The term "guideline level premium" means the level annual amount, payable over a period not ending before the insured attains age 95, computed on the same basis as the guideline single premium, except that paragraph (3)(B)(iii) shall be applied by substituting "4 percent" for "6 percent".

(d) **Cash value corridor for purposes of subsection (a)(2)(B).**—For purposes of this section—

(1) **In general.**—A contract falls within the cash value corridor of this subsection if the death benefit under

the contract at any time is not less than the applicable percentage of the cash surrender value.

(2) **Applicable percentage.**— In the case of an insured with an attained age as of the beginning of the contract year of: The applicable percentage shall decrease by a ratable portion for each full year:

In the case of an insured with an attained age as of the beginning of the contract year of:	The applicable percentage shall decrease by a ratable portion for each full year
0 40	250 250
40 45	250 215
45 50	215 185
50 55	185 150
55 60	150 130
60 65	130 120
65 70	120 115
70 75	115 105
75 90	105 105
90 95	105 100

(e) Computational rules.—

(1) **In general.**—For purposes of this section (other than subsection (d))—

(A) the death benefit (and any qualified additional benefit) shall be deemed not to increase,

(B) the maturity date, including the date on which any benefit described in subparagraph (C) is pay-

able, shall be deemed to be no earlier than the day on which the insured attains age 95, and no later than the day on which the insured attains age 100,

(C) the death benefits shall be deemed to be provided until the maturity date determined by taking into account subparagraph (B), and

(D) the amount of any endowment benefit (or sum of endowment benefits, including any cash surrender value on the maturity date determined by taking into account subparagraph (B)) shall be deemed not to exceed the least amount payable as a death benefit at any time under the contract.

(2) Limited increases in death benefit permitted.—Notwithstanding paragraph (1)(A)—

(A) for purposes of computing the guideline level premium, an increase in the death benefit which is provided in the contract may be taken into account but only to the extent necessary to prevent a decrease in the excess of the death benefit over the cash surrender value of the contract,

(B) for purposes of the cash value accumulation test, the increase described in subparagraph (A) may be taken into account if the contract will meet such test at all times assuming that the net level reserve (determined as if level annual premiums were paid for the contract over a period not ending before the insured attains age 95) is substituted for the net single premium, and

(C) for purposes of the cash value accumulation test, the death benefit increases may be taken into account if the contract—

(i) has an initial death benefit of $5,000 or less and a maximum death benefit of $25,000 or less,

(ii) provides for a fixed predetermined annual increase not to exceed 10 percent of the initial death benefit or 8 percent of the death benefit at the end of the preceding year, and

(iii) was purchased to cover payment of burial expenses or in connection with prearranged funeral expenses.

For purposes of subparagraph (C), the initial death benefit of a contract shall be determined by treating all contracts issued to the same contract owner as 1 contract.

(f) Other definitions and special rules.—For purposes of this section—

(1) Premiums paid.—

(A) In general.—The term "premiums paid" means the premiums paid under the contract less amounts (other than amounts includible in gross income) to which section 72(e) applies and less any excess premiums with respect to which there is a distribution described in subparagraph (B) or (E) of paragraph (7) and any other amounts received with respect to the contract which are specified in regulations.

(B) Treatment of certain premiums returned to policyholder.—If, in order to comply with the requirements of subsection (a)(2)(A), any portion of any premium paid during any contract year is returned by the insurance company (with interest) within 60 days after the end of a contract year, the amount so returned (excluding interest)

shall be deemed to reduce the sum of the premiums paid under the contract during such year.

(C) Interest returned includible in gross income.—Notwithstanding the provisions of section 72(e), the amount of any interest returned as provided in subparagraph (B) shall be includible in the gross income of the recipient.

(2) Cash values.—

(A) Cash surrender value.—The cash surrender value of any contract shall be its cash value determined without regard to any surrender charge, policy loan, or reasonable termination dividends.

(B) Net surrender value.—The net surrender value of any contract shall be determined with regard to surrender charges but without regard to any policy loan.

(3) Death benefit.—The term "death benefit" means the amount payable by reason of the death of the insured (determined without regard to any qualified additional benefits).

(4) Future benefits.—The term "future benefits" means death benefits and endowment benefits.

(5) Qualified additional benefits.—

(A) In general.—The term "qualified additional benefits" means any—

(i) guaranteed insurability,

(ii) accidental death or disability benefit,

(iii) family term coverage,

(iv) disability waiver benefit, or

(v) other benefit prescribed under regulations.

(B) **Treatment of qualified additional benefits.**—For purposes of this section, qualified additional benefits shall not be treated as future benefits under the contract, but the charges for such benefits shall be treated as future benefits.

(C) **Treatment of other additional benefits.**—In the case of any additional benefit which is not a qualified additional benefit—

(i) such benefit shall not be treated as a future benefit, and

(ii) any charge for such benefit which is not prefunded shall not be treated as a premium.

(6) **Premium payments not disqualifying contract.**—The payment of a premium which would result in the sum of the premiums paid exceeding the guideline premium limitation shall be disregarded for purposes of subsection (a)(2) if the amount of such premium does not exceed the amount necessary to prevent the termination of the contract on or before the end of the contract year (but only if the contract will have no cash surrender value at the end of such extension period).

(7) **Adjustments.**—

(A) **In general.**—If there is a change in the benefits under (or in other terms of) the contract which was not reflected in any previous determination or adjustment made under this section, there shall be proper adjustments in future determinations made under this section.

(B) **Rule for certain changes during first 15 years.**—If—

(i) a change described in subparagraph (A) reduces benefits under the contract,

(ii) the change occurs during the 15-year period beginning on the issue date of the contract, and

(iii) a cash distribution is made to the policyholder as a result of such change, section 72 (other than subsection (e)(5) thereof) shall apply to such cash distribution to the extent it does not exceed the recapture ceiling determined under subparagraph (C) or (D) (whichever applies).

(C) **Recapture ceiling where change occurs during first 5 years.**—If the change referred to in subparagraph (B)(ii) occurs during the 5-year period beginning on the issue date of the contract, the recapture ceiling is—

(i) in the case of a contract to which subsection (a)(1) applies, the excess of—

(I) the cash surrender value of the contract, immediately before the reduction, over

(II) the net single premium (determined under subsection (b)), immediately after the reduction, or

(ii) in the case of a contract to which subsection (a)(2) applies, the greater of—

(I) the excess of the aggregate premiums paid under the contract, immediately before the reduction, over the guideline premium limitation for the contract (determined under subsection (c)(2), taking

into account the adjustment described in subparagraph (A)), or

(II) the excess of the cash surrender value of the contract, immediately before the reduction, over the cash value corridor of subsection (d) (determined immediately after the reduction).

(D) **Recapture ceiling where change occurs after 5th year and before 16th** year.—**If the change referred to in subparagraph (B) occurs after the 5-year** period referred to under subparagraph (C), the recapture ceiling is the excess of the cash surrender value of the contract, immediately before the reduction, over the cash value corridor of subsection (d) (determined immediately after the reduction and whether or not subsection (d) applies to the contract).

(E) **Treatment of certain distributions made in anticipation of benefit** reductions.—**Under regulations prescribed by the Secretary, subparagraph (B)** shall apply also to any distribution made in anticipation of a reduction in benefits under the contract. For purposes of the preceding sentence, appropriate adjustments shall be made in the provisions of subparagraphs (C) and (D); and any distribution which reduces the cash surrender value of a contract and which is made within 2 years before a reduction in benefits under the contract shall be treated as made in anticipation of such reduction.

(8) **Correction of errors.**—If the taxpayer establishes to the satisfaction of the Secretary that—

(A) the requirements described in subsection (a) for any contract year were not satisfied due to reasonable error, and

(B) reasonable steps are being taken to remedy the error, the Secretary may waive the failure to satisfy such requirements.

(9) **Special rule for variable life insurance contracts.**—In the case of any contract which is a variable contract (as defined in section 817), the determination of whether such contract meets the requirements of subsection (a) shall be made whenever the death benefits under such contract change but not less frequently than once during each 12-month period.

(g) Treatment of contracts which do not meet subsection (a) test.—

(1) **Income inclusion.—**

(A) **In general.**—If at any time any contract which is a life insurance contract under the applicable law does not meet the definition of life insurance contract under subsection (a), the income on the contract for any taxable year of the policyholder shall be treated as ordinary income received or accrued by the policyholder during such year.

(B) **Income on the contract.**—For purposes of this paragraph, the term "income on the contract" means, with respect to any taxable year of the policyholder, the excess of—

(i) the sum of—

(I) the increase in the net surrender value of the contract during the taxable year, and

(II) the cost of life insurance protection provided under the contract during the taxable year, over

(ii) the premiums paid (as defined in subsection (f)(1)) under the contract during the taxable year.

(C) **Contracts which cease to meet definition.**—If, during any taxable year of the policyholder, a contract which is a life insurance contract under the applicable law ceases to meet the definition of life insurance contract under subsection (a), the income on the contract for all prior taxable years shall be treated as received or accrued during the taxable year in which such cessation occurs.

(D) **Cost of life insurance protection.**—For purposes of this paragraph, the cost of life insurance protection provided under the contract shall be the lesser of—

(i) the cost of individual insurance on the life of the insured as determined on the basis of uniform premiums (computed on the basis of 5-year age brackets) prescribed by the Secretary by regulations, or

(ii) the mortality charge (if any) stated in the contract.

(2) **Treatment of amount paid on death of insured.**—If any contract which is a life insurance contract under the applicable law does not meet the definition of life insurance contract under subsection (a), the excess of the amount paid by the reason of the death of the insured over the net surrender value of the contract shall be deemed to be paid under a life insurance contract for purposes of section 101 and subtitle B.

(3) **Contract continues to be treated as insurance contract.**—If any contract which is a life insurance contract under the applicable law does not meet the definition of life insurance contract under subsection (a), such contract shall, notwithstanding such failure, be treated as an insurance contract for purposes of this title.

(h) **Endowment contracts receive same treatment.**—

(1) **In general.**—References in subsections (a) and (g) to a life insurance contract shall be treated as including references to a contract which is an endowment contract under the applicable law.

(2) **Definition of endowment contract.**—For purposes of this title (other than paragraph (1)), the term "endowment contract" means a contract which is an endowment contract under the applicable law and which meets the requirements of subsection (a).

(i) **Transitional rule for certain 20-pay contracts.**—

(1) **In general.**—In the case of a qualified 20-pay contract, this section shall be applied by substituting "3 percent" for "4 percent" in subsection (b)(2).

(2) **Qualified 20-pay contract.**—For purposes of paragraph (1), the term "qualified 20-pay contract" means any contract which—

(A) requires at least 20 nondecreasing annual premium payments, and

(B) is issued pursuant to an existing plan of insurance.

(3) **Existing plan of insurance.**—For purposes of this subsection, the term "existing plan of insurance" means, with respect to any contract, any plan of in-

surance which was filed by the company issuing such contract in 1 or more States before September 28, 1983, and is on file in the appropriate State for such contract.

(j) Certain church self-funded death benefit plans treated as life insurance.—

(1) In general.—In determining whether any plan or arrangement described in paragraph (2) is a life insurance contract, the requirement of subsection (a) that the contract be a life insurance contract under applicable law shall not apply.

(2) Description.—For purposes of this subsection, a plan or arrangement is described in this paragraph if—

(A) such plan or arrangement provides for the payment of benefits by reason of the death of the individuals covered under such plan or arrangement, and

(B) such plan or arrangement is provided by a church for the benefit of its employees and their beneficiaries, directly or through an organization described in section 414(e)(3)(A) or an organization described in section 414(e)(3)(B)(ii).

(3) Definitions.—For purposes of this subsection—

(A) Church.—The term "church" means a church or a convention or association of churches.

(B) Employee.—The term "employee" includes an employee described in section 414(e)(3)(B).

(k) Regulations.—The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section.

HEALTH INSURANCE PORTABILITY & ACCOUNTABILITY ACT, PUB. L. NO. 104-191, § 501, 110 STAT. 1936 2090-93 (1996)

§ 501. DENIAL OF DEDUCTION FOR INTEREST ON LOANS WITH RESPECT TO COMPANY- OWNED LIFE INSURANCE.

(a) In general.—Paragraph (4) of section 264(a) is amended—

(1) by inserting ", or any endowment or annuity contracts owned by the taxpayer covering any individual," after "the life of any individual", and

(2) by striking all that follows "carried on by the taxpayer" and inserting a period.

(b) Exception For Contracts Relating To Key Persons; Permissible Interest Rates.—§ 264 is amended—

(1) by striking "Any" in subsection (a)(4) and inserting "Except as provided in subsection (d), any", and

(2) by adding at the end the following new subsection:

"(d) SPECIAL RULES FOR APPLICATION OF SUBSECTION (a)(4).—

"(1) EXCEPTION FOR KEY PERSONS.—Subsection (a)(4) shall not apply to any interest paid or accrued on any indebtedness with respect to policies or contracts covering an individual who is a key person to the extent that the aggregate amount of such indebtedness with respect to policies and contracts covering such individual does not exceed $50,000.

"(2) INTEREST RATE CAP ON KEY PERSONS AND PRE-1986 CONTRACTS.—

"(A) IN GENERAL.—No deduction shall be allowed by reason of paragraph (1) or the last sentence of subsection (a) with respect to interest paid or accrued for any month beginning after December 31, 1995, to the extent the amount of such interest exceeds the amount which would have been determined if the applicable rate of interest were used for such month.

"(B) APPLICABLE RATE OF INTEREST.—For purposes of subparagraph (A)—

"(i) IN GENERAL.—The applicable rate of interest for any month is the rate of interest described as Moody's Corporate Bond Yield Average-Monthly Average Corporates as published by Moody's Investors Service, Inc., or any successor thereto, for such month.

"(ii) PRE-1986 CONTRACTS.—In the case of indebtedness on a contract purchased on or before June 20, 1986—

"(I) which is a contract providing a fixed rate of interest, the applicable rate of interest for any month shall be the Moody's rate described in clause (i) for the month in which the contract was purchased, or

"(II) which is a contract providing a variable rate of interest, the applicable rate of interest for any month in an applicable period shall be such Moody's rate for the third month preceding the first month in such period.

For purposes of subclause (II), the taxpayer shall elect an applicable period for such contract on its return of tax im-

posed by this chapter for its first taxable year ending on or after October 13, 1995. Such applicable period shall be for any number of months (not greater than 12) specified in the election and may not be changed by the taxpayer without the consent of the Secretary.

"(3) KEY PERSON.—For purposes of paragraph (1), the term 'key person' means an officer or 20-percent owner, except that the number of individuals who may be treated as key persons with respect to any taxpayer shall not exceed the greater of—

"(A) 5 individuals, or

"(B) the lesser of 5 percent of the total officers and employees of the taxpayer or 20 individuals.

"(4) 20-PERCENT OWNER.—For purposes of this subsection, the term '20-percent owner' means—

"(A) if the taxpayer is a corporation, any person who owns directly 20 percent or more of the outstanding stock of the corporation or stock possessing 20 percent or more of the total combined voting power of all stock of the corporation, or

"(B) if the taxpayer is not a corporation, any person who owns 20 percent or more of the capital or profits interest in the employer.

"(5) AGGREGATION RULES.—

"(A) IN GENERAL.—For purposes of paragraph (4)(A) and applying the $50,000 limitation in paragraph (1)—

"(i) all members of a controlled group shall be treated as one taxpayer, and

"(ii) such limitation shall be allocated among the members of such group in such manner as the Secretary may prescribe.

"(B) CONTROLLED GROUP.—For purposes of this paragraph, all persons treated as a single employer under subsection (a) or (b) of section 52 or subsection (m) or (o) of section 414 shall be treated as members of a controlled group.".

(c) Effective Dates.—

(1) In general.—The amendments made by this section shall apply to interest paid or accrued after October 13, 1995.

(2) Transition Rule For Existing Indebtedness.—

(A) In general.—In the case of—

(i) indebtedness incurred before January 1, 1996, or

(ii) indebtedness incurred before January 1, 1997 with respect to any contract or policy entered into in 1994 or 1995, the amendments made by this section shall not apply to qualified interest paid or accrued on such indebtedness after October 13, 1995, and before January 1, 1999.

(B) Qualified Interest.—For purposes of subparagraph (A), the qualified interest with respect to any indebtedness for any month is the amount of interest (otherwise deductible) which would be paid or accrued for such month on such indebtedness if—

(i) in the case of any interest paid or accrued after December 31, 1995, indebtedness with re-

spect to no more than 20,000 insured individuals were taken into account, and

(ii) the lesser of the following rates of interest were used for such month:

(I) The rate of interest specified under the terms of the indebtedness as in effect on October 13, 1995 (and without regard to modification of such terms after such date).

(II) The applicable percentage of the rate of interest described as Moody's Corporate Bond Yield Average-Monthly Average Corporates as published by Moody's Investors Service, Inc., or any successor thereto, for such month.

For purposes of clause (i), all persons treated as a single employer under subsection (a) or (b) of section 52 of the Internal Revenue Code of 1986 or subsection (m) or (o) of section 414 of such Code shall be treated as 1 person. Subclause (II) of clause (ii) shall not apply to any month before January 1, 1996.

(C) **Applicable Percentage.**—For purposes of subparagraph (B), the applicable percentage is as follows:

(3) **Special Rule For Grandfathered Contracts.**—This section shall not apply to any contract purchased on or before June 20, 1986, except that section 264(d)(2) of the Internal Revenue Code of 1986 shall apply to interest paid or accrued after October 13, 1995.

(d) **Spread Of Income Inclusion On Surrender, Etc. Of Contracts.—**

(1) **In general.**—If any amount is received under any life insurance policy or endowment or annuity contract described in paragraph (4) of section 264(a) of the Internal Revenue Code of 1986—

(A) on the complete surrender, redemption, or maturity of such policy or contract during calendar year 1996, 1997, or 1998, or

(B) in full discharge during any such calendar year of the obligation under the policy or contract which is in the nature of a refund of the consideration paid for the policy or contract, then (in lieu of any other inclusion in gross income) such amount shall be includible in gross income ratably over the 4-taxable year period beginning with the taxable year such amount would (but for this paragraph) be includible. The preceding sentence shall only apply to the extent the amount is includible in gross income for the taxable year in which the event described in subparagraph (A) or (B) occurs.

(2) **Special Rules For Applying § 264.**—A contract shall not be treated as—

(A) failing to meet the requirement of section 264(c)(1) of the Internal Revenue Code of 1986, or

(B) a single premium contract under section 264(b)(1) of such Code, solely by reason of an occurrence described in subparagraph (A) or (B) of paragraph (1) of this subsection or solely by reason of no additional premiums being received under the contract by reason of a lapse occurring after October 13, 1995.

(3) **Special Rule For Deferred Acquisition Costs.**—In the case of the occurrence of any event described in

subparagraph (A) or (B) of paragraph (1) of this subsection with respect to any policy or contract—

(A) § 848 of the Internal Revenue Code of 1986 shall not apply to the unamortized balance (if any) of the specified policy acquisition expenses attributable to such policy or contract immediately before the insurance company's taxable year in which such event occurs, and

(B) there shall be allowed as a deduction to such company for such taxable year under chapter 1 of such Code an amount equal to such unamortized balance.

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